A change in focus

TONY ANDERSON LOOKS AT GRANTING FINANCIAL ASSISTANCE AND HOW A CHANGE IN LAW BRINGS A CHANGE IN FOCUS.

Executive summary

- The Companies Act 2006 may provide opportunities for companies to achieve greater market share via trade acquisitions, and private companies can now grant financial assistance towards the acquisition of their own shares without whitewashing.

Provisions of the Companies Act 2006, which came into effect on 1 October this year, may provide opportunities for companies to achieve greater market share via trade acquisitions at the same time as reducing transaction costs. But directors of target companies will now need to be more mindful of the common law duties they owe to their companies in such transactions.

These provisions allow a private company to grant financial assistance towards the acquisition of its own shares or that of its private holding company without the need to "whitewash" such financial assistance. It still remains unlawful in the UK to provide financial assistance for the acquisition of shares in a public company.

Financial assistance often takes the form of guarantees or security provided by the assisting company to the lender funding the acquisition for the purchaser. It also includes loans made to the purchaser from its newly acquired operating subsidiaries to enable it to repay the acquisition loan. These new provisions could significantly reduce the deal costs associated with the acquisition of companies, depending on the consideration paid for the target and the number of assisting companies involved.

WHITEWASH In the past, where the consideration paid for an acquisition was relatively small, the costs associated with the whitewash procedure may have sometimes seemed disproportionate. Similarly where the number of assisting companies in the group being acquired does not have a direct correlation to the acquisition price, transaction costs may have also seemed high due to the number of whitewashes to be performed.

Previously all the directors of a company providing financial assistance (and not just those required to execute the transaction documents), as well as all of the directors of its holding companies, up to and including the target company, were each required to swear a statutory declaration as to the solvency of the relevant assisting company for the 12-month period following the grant of the assistance. The auditors of each assisting company were also required to author a statutory report affirming the solvency declarations made by the directors of these companies. It had become customary for the auditors also to provide a letter of comfort to the lender regarding the net asset position of the assisting company (the net asset letter).

Where the assisting company was not wholly owned, shareholder approval of such assistance was also required. Lenders, however, generally required shareholder approval even where the assisting company was wholly owned. These various, document-intensive steps were collectively known as the whitewash.

The whitewash usually resulted in considerable amounts of additional time and cost being incurred in such acquisitions due to the need to retain auditors to review the assisting company's balance sheet and solvency position going forward, as well as lawyers to produce large amounts of documentation and to co-ordinate its execution by all directors and shareholders (usually out of business hours, when these transactions have a tendency to complete).

NEW LEGISLATION From 1 October 2008 there is no longer a requirement to follow the whitewash procedure. While these restrictions have been removed there will still be a need to consider the maintenance of capital of the assisting company and whether any unlawful distributions have been made by the company. At common law a company's capital needs to be protected for the benefit of its creditors.

Any reduction in the company's net assets as a result of the financial assistance must still be provided out of the distributable profits of that company and more obviously where a company is providing assistance, the provision of the assistance must be in the

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best interests of that company and likely to promote its financial success. The directors of the company have a duty to consider this in their board resolutions but can get comfort from obtaining shareholder approval for the provision of the assistance. This will avoid the possibility of a shareholder challenging the transaction on the basis that the directors had breached their duties. Board minutes need to reflect these considerations and resolutions. The company's solvency then still needs to be considered.

Such provisions concerning net asset reduction, promotion of financial success and solvency have always existed and were not affected by the repeal of the whitewash regime. However, the whitewash provided comfort in relation to these common law issues being addressed and as a result they were not always at the forefront of the transaction parties' considerations. Following repeal of the financial assistance prohibition for private companies and the whitewash procedure, these common law issues will now receive closer attention.

A NEW FOCUS It is important to remember that if the company providing the assistance is insolvent or at risk of becoming insolvent, there is a potential for the transaction to be challenged on the basis that the directors have breached their duties or that it is a transaction at undervalue, or a preference. This will be a further factor for directors to consider at board level and to be included in their minutes.

This will be particularly relevant during the hardening period applicable to fixed security under the Insolvency Act. Any payments made in favour of secured creditors whose security is put in place after loan proceeds have advanced, and within six months ending with the onset of the insolvency of a company, can be challenged as a preference.

While auditors will no longer be providing statutory reports to give directors comfort with respect to the acquisition, it will become incumbent on the acquiring company (and its funder) to assess the solvency of the assisting companies as part of their legal, operational and financial due diligence of the acquisition. To do this, they will need to look at the assisting companies' net asset positions and the sufficiency of their cashflows going forward while also taking account of any contingent liabilities as part of this analysis. In the current market this will place greater emphasis and reliance on the financial modelling, forecasts and due diligence process commissioned for the acquisition to ensure that the directors have a sufficient basis to resolve accordingly.

It is currently envisaged that lenders to such acquisitions are not likely to insist on requiring net asset letters from the auditors of any assisting companies. However, as during the whitewash regime, lenders will still seek to have the various legal, operational and financial due diligence reports addressed to them or be subject to letters of reliance from the authors of such reports in their favour. There are suggestions that it will be difficult for the authors of financial due diligence reports or legal due diligence reports to comment on the contingency of security or guarantees as the likelihood of these obligations being called has increased significantly in the current climate. This will put further pressure on the directors and their funders when structuring these transactions.

There are suggestions that they may also look to the directors of the assisting companies to certify certain matters including the solvency of their companies. Such requirements should be resisted by directors.

In transactions it is common for lenders to obtain directors' certificates as to certain information concerning the relevant borrower or security provider. These certificates focus on documentation such as the board resolutions approving the entry into transaction security, or the constitutional documents of the company. These documents are usually appended to the certificate and the director certifies that they are true, correct and up to date. To expand this mechanism to encompass the solvency of the company would not sit comfortably with directors.

In the present climate it is apparent that the decision by lenders to fund any acquisitions will be scrutinised meticulously on a case by case basis. The likelihood of contingent liabilities being called has increased significantly, which makes the assessment of the net asset position of an assisting company particularly difficult. The contents of due diligence and forecasting reports are likely to receive even more attention from companies, lenders and their respective advisers. This will particularly be the case, now that a longstanding regulatory given has been removed from the transaction process.

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