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# Corporate Legal Alert

## Who cares about financial assistance now?

**As explained in our corporate legal alert "The Companies Act 2006: What's happening on 1 October 2008", the financial assistance regime was partially repealed on 1 October 2008. This alert focuses on the circumstances where the financial assistance regime continues to apply.**

### The financial assistance regime

The statutory prohibition on companies providing financial assistance for the purchase of their own shares is currently contained in the Companies Act 1985.

In summary, the categories of unlawful financial assistance are:

(a) financial assistance given by way of gift;

(b) financial assistance given by way of guarantee, security or indemnity, other than an indemnity in respect of the indemnifier's own neglect or default, or by way of release or waiver;

(c) financial assistance given by way of a loan or similar agreement; and

(d) any other financial assistance given by a company which has no net assets or whose net assets are reduced to a material extent as a result of the financial assistance.

These categories remain unchanged, notwithstanding the partial repeal of the financial assistance regime.

#### The law before 1 October 2008

November 2008

Before 1 October 2008, both public and private companies and their respective subsidiaries were, subject to a number of exceptions, prohibited from giving financial

assistance for the acquisition of shares in the relevant public or private company. This general prohibition was relaxed for private companies if they carried out what colloquially became known as a "whitewash" procedure.

### Partial repeal

On 1 October 2008, the financial assistance regime was repealed to the extent it applied to most private company transactions, so that private companies are no longer prohibited from providing financial assistance for the purchase of their own shares or shares in another private company. Consequently, the "whitewash" procedure has become obsolete. The repeal applies in relation to financial assistance given on or after 1 October 2008.

## When does the financial assistance regime continue to apply?

### Private companies

Private companies continue to be prohibited from providing financial assistance for the purchase of shares in their parent company **if that parent company is a public company**.

### Public companies

Public companies continue to be prohibited from providing financial assistance for the purchase of their own shares or shares in their parent company. The Companies Act 2006 provisions relating to financial assistance by public companies are expected to come into force on 1 October 2009. Until then, the financial assistance provisions of the Companies Act 1985 (ss151 to 154) continue to apply in relation to public companies as before.

A general prohibition on public companies giving financial assistance is required by European law under the Second Company Law Directive (77/91/EC). Whilst the Second Company Law Directive (as amended in 2006) gives member states the option to relax in part the prohibition on public companies giving financial assistance, it is understood that the UK government does not currently intend to take advantage of this option.

## Examples

Set out below are some examples of situations where a public or private company could enter into a transaction which amounts to unlawful financial assistance. These examples are by no means exhaustive, but are intended to highlight where financial assistance issues can still arise.

### Break fees

Before making a takeover offer, a bidder may ask the target to agree to pay the bidder a break fee if the proposed takeover fails. Paying or agreeing to pay a break fee in the context of a public takeover offer could in certain circumstances be unlawful financial assistance falling within category (d), for example if the target has no net assets or the break fee amounts to a material reduction in net assets. Although there is no statutory definition or judicial interpretation of "material", market practice suggests that more than a 1% reduction in net assets could be considered material for these purposes. However, this is only a "rule of thumb" and each case must be considered on its own

facts. The requirement that any reduction in net assets is not material should not be confused with the separate requirement under the City Code on Takeovers and Mergers that break fees must be de minimis (usually no more than 1% of the offer value) or the Listing Rules (LR10.2.7R) which provide, in effect, that a break fee above 1% of the offer price or 1% of market capitalisation (in circumstances where the listed company is not itself being acquired) is treated as a class 1 transaction.

Paying or agreeing to pay a break fee could also be unlawful financial assistance falling within category (b) if the break fee operates to indemnify the bidder, for example for costs incurred in relation to the potential takeover offer. To avoid falling within category (b), the break fee should be contractually agreed at the outset in effect as an inducement for making the offer and should not be directly connected to or expressed as an indemnity in respect of the bidder's anticipated costs.

## Acquisition financing

A buyer of a company will often borrow third party funds to finance the purchase. The lender will typically look to the target and other members of the target group to guarantee the buyer's obligations to, and to grant security over their assets in favour of, the lender. This is particularly relevant in a public to private buyout, where the buyer (which is likely to be a new company with no assets of its own other than its shares in the target) is looking to acquire a publicly traded company. The giving of guarantees and granting of security by a public company target and its subsidiaries (whether public or private companies) to secure the acquisition finance will be unlawful financial assistance falling within category (b). However, if the target is re-registered as a private company following the acquisition, the target and its private company subsidiaries will then be able to give guarantees and grant security in favour of the lender without this constituting unlawful financial assistance - the target is not a public company at the time the financial assistance is given. Whilst re-registering a public company target as a private company in these circumstances is not new practice, it is no longer necessary for the private company to carry out a formal whitewash procedure before giving the financial assistance.

## Indemnities

A public company may be asked to give indemnities in connection with the purchase of or subscription for its shares. Care should continue to be taken to ensure such an indemnity does not constitute unlawful financial assistance. For example, it remains the case that a company cannot lawfully indemnify a purchaser of its shares for losses incurred on resale – quite apart from the market abuse and City Code on Takeovers and Mergers implications.

The most common cases where an indemnity can usually lawfully be given by a public company in connection with a subscription or purchase of shares are:

(a) **an underwriting indemnity** – it is common for a company which is being floated on a public market or publicly marketing its shares to be asked to indemnify the sponsor, underwriters and placement agents against liabilities incurred in relation to the proper performance of their role. Such an indemnity is not given for the

purpose of an acquisition of shares in the public company and as it is a general indemnity given without any expectation that it will be called upon, cannot be said to assist the acquisition. Accordingly, it should not fall foul of the financial assistance regime. This analysis will of course depend on the particular circumstances of a transaction and for example may be different if the financial institution concerned is itself planning to acquire shares in the offering other than through its underwriting risk, or if the indemnity is unusual in any particular respect; and

(b) **an indemnity for breach of warranty** – here the indemnity itself may not be unlawful if it is being given in respect of the public company's own neglect or default, because of the carve out in category (b).

If a public company is unable to give an indemnity in connection with the acquisition of its own shares because to do so would amount to unlawful financial assistance, a private company subsidiary cannot give the indemnity in place of its public company parent.

### Auction share sales

It is likely that professional costs will be incurred if a company is being prepared for sale. For example, lawyers, bankers, accountants and other professional advisers may be asked to assist in putting together a data room and / or producing an information memorandum or due diligence reports.

If the target is a public company, it remains the case that consideration needs to be given to whether payment by the target of costs incurred after a purchaser has been identified constitutes financial assistance (if the target is a private company, financial assistance is no longer an issue, although other considerations continue to apply as before). If the public company target is paying the fees of its own professional advisers, this will fall within category (d), and will not be unlawful financial assistance if the public company target has positive net assets and the fees will not amount to a material reduction in those net assets. If the public company target is paying the seller's fees this is akin to an indemnity (in relation to which there is no materiality test) and could constitute unlawful financial assistance falling within category (b).

## Conclusion

The repeal of the financial assistance regime for private companies has been well publicised. However, it is important to note that the repeal was only partial. **Questions about whether a transaction involves unlawful financial assistance remain in cases where shares of a public company are being acquired even if the assistance is being given by a private company.**

**If you have any questions or require specific advice on any matter discussed in this publication, please contact Justine Usher (T: +44 (0)20 7782 8517 or E: jusher@mayerbrown.com) or your regular contact at Mayer Brown.**

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