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Private Equity Portfolio Company Bulletin

Employee loans – consumer credit pitfalls

Many people are aware of the tax issues that can arise when making loans to employees with an interest rate below HMRC's "official rate" (which reduced to 2.5% per annum on 6 April 2017).

Less well known are the problems that can arise under the consumer credit regime. In some cases this is not considered, and where it is considered, it is often thought that lending to employees is nothing to do with consumer credit, or that as the company is not in the business of making loans the regime will not apply. Both of these are misconceptions.

The regime was rejigged as of 1 April 2014, and the legislation is now largely contained in the Financial Services and Markets Act 2000 and its subsidiary legislation. Loans to employees are caught, whether or not the lender is in the business of making loans, unless an exemption can be found. If there is no applicable exemption the lender will need to be authorised by the Financial Conduct Authority, and if the loan is made by an unauthorised lender there may be problems with enforcing its repayment. The problem is that there is no easy "one-size-fits-all" exemption applying to employee loans.

Two of the most useful exemptions in this context are for high net worth borrowers, and for low-cost credit agreements.

For an individual to be a high net worth borrower he basically needs to have net annual income (after tax) of £150,000, or net assets, excluding primary residence, in excess of £500,000. However, to fall within the exemption there are very specific requirements to be met in the loan documentation, and a statement of high net worth needs to be made by, in most cases, a suitably qualified accountant. However, for senior employees this gives more flexibility than the low-cost credit agreement exemption, and may in particular be useful where a loan is to be made to fund the acquisition of shares from a company other than the lender. Please note that this exemption will only apply if the amount being advanced is in excess of £60,260.

The low-cost credit agreement exemption initially sounds attractive, but there are some tricky requirements in connection with employee loans unrelated to the cost of credit. The low-cost element is easily achieved by (basically) not charging more than 1% above the base rate of certain specified banks (although this will likely be less than the official rate, so the employee will need to pay tax on a deemed interest benefit). The other requirements are that the loan must be structured as a borrower-lender agreement, and not a borrower-lender-supplier agreement, and the loan must come from a company in the same group as the employer.

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A detailed consideration of the definitions of borrower-lender and borrower-lender-supplier agreements is beyond the scope of this article, but difficulties arise in particular where the employee is being lent money to buy shares in a group company, as this would tend to be a borrower-lender-supplier agreement. In this case, it is thought the loan could still fall within the exemption provided that the company lending the money is the same company as that supplying the shares (and is the employer company or in the same group as the employer company) AND the employee has the opportunity to use the loan money for other purposes – for example, because the money is paid into the employee's bank account. This second limb could still be met even if the terms of the loan require the money to be applied in the acquisition of the shares.

If no exemption can be found, then the FCA authorisation route may be less onerous than at first thought. Where the loans are not made in the course of a business, there is a relatively light-touch authorisation regime. Generally easier to go the extra mile to fit into an exemption though.

Duty to Report on Payment Practices and Performance

The new Reporting on Payment Practices and Performance Regulations 2017 came into force on 6 April 2017 and require all large companies incorporated in the UK to report on payment practices, policies and performance twice a year. The regulations aim to provide greater transparency regarding the terms of larger business' contract payments and their reliability in making those payments on time. The new legislation is designed to give smaller businesses a greater degree of comfort regarding those they do business with, without unduly interfering with the freedom of contract.

The regulations apply to (broadly) UK companies and LLPs that meet certain size criteria. An individual company (see below for group company test) will be caught by these regulations if, on its last two balance sheet dates, it exceeded two of the three thresholds set out below:

- £36 million annual turnover;
- £18 million balance sheet total (i.e. total assets on company balance sheet); or
- 250 employees.

A subsidiary must report on its own payment practices if it meets the above threshold test on an individual basis. A parent company, on the other hand, will only be required to report on its own payment practices if:

i) it meets the above threshold test on an individual basis; and

ii) the group of companies it heads also meets a second test.

The second test requires the group to exceed two out of the following three thresholds on its last two balance sheet dates:

- aggregate turnover £43.2 million gross (£36 million net);
- balance sheet total £21.6 million gross (£18 million net);
- 250 employees.

Net totals include set-offs and adjustments for group transactions whereas the gross figures exclude these alterations.

A company in its first year of incorporation is exempt from these regulations and is not expected to make a report until the following year if it meets the size criteria.

Companies will be required to report on "qualifying contracts" between two or more businesses for goods, services and tangible property (including IP). Qualifying contracts are contracts that have a "significant connection" to the UK. The governing law chosen by the parties will not be necessarily determine whether a contract has a significant connection to the UK. This will depend on where the contract is to be performed and where the parties are established or whether they carry on the relevant part of their business in the UK. Contracts for financial services do not fall under qualifying contracts.

The information to be published in relation to qualifying contracts includes the following areas:

- standard and maximum payment period;
- process for resolving payment disputes;
- statistics relating to average number of days taken to make payments and percentage of payments made within defined periods;
- whether the business operates a "pay to stay" policy;
- whether the business is a member of a payment code (such as the Prompt Payment Code).

Companies have to publish the required information twice a year using a digital service provided by the government.

If they haven't done so already, companies should be assessing whether they fall within the scope of the regime. If they do, they need to be evaluating their invoicing process and considering the procedure and policies they will adopt in order to collate information for qualifying contracts efficiently. This will involve training procurement personnel and the accounting team as well as in-house counsel to ensure compliance across the company's departments. Companies may also wish to consider whether their standard terms are conducive to prompt payment practices and the collection of aggregated payment data.

Are reasonable or best endeavours undertakings enforceable if they involve an agreement to agree?

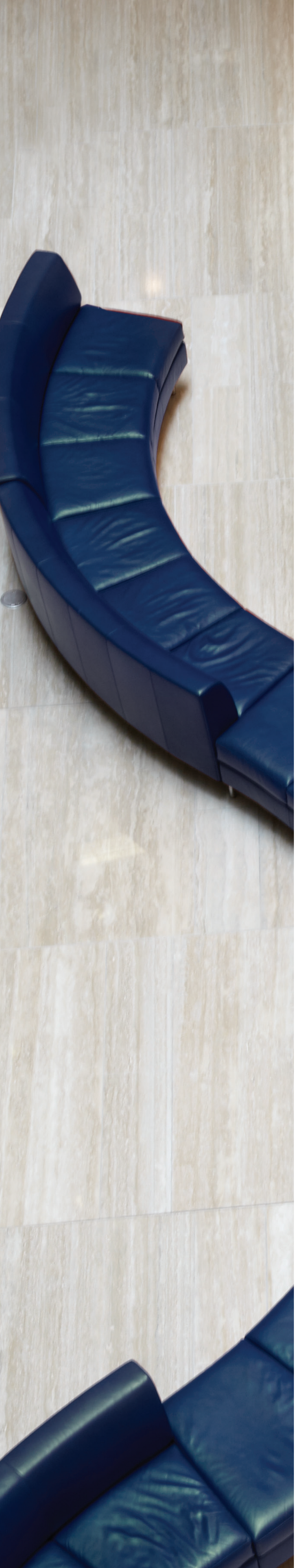
What are the facts of the case?

The case of *Astor v Atalaya*[1] involved a copper ore mining project in southern Spain. Atalaya, a mining company, agreed with Astor, an investor in the project, to use all reasonable endeavours to obtain a debt facility. Atalaya's promise essentially involved an undertaking to enter into an agreement with a third party.

What is an agreement to agree?

A so-called agreement to agree is unenforceable. An agreement between two parties to continue negotiating until a final binding agreement between them, or between one of them and a third party, is reached is incomplete because it does not include the terms of the contract. It lacks certainty which is one of the fundamental requirements for forming a contract under English Law. How does this affect an undertaking to use reasonable endeavours to reach an agreement?

1 *Astor Management AG v Atalaya Mining* [2017] EWHC



The Astor v Atalaya decision

This issue has already been considered in another case (*Dany Lions*)[2]. Here, the court said any endeavours obligation requires both certainty of object *and* sufficient objective criteria by which to measure the endeavours taken. The obligation in that case was not certain enough to be enforceable as the object of the endeavours was a future agreement and key terms such as price were still outstanding. However, the court said there should be a different approach where the object of the endeavours is clearly defined, for example, obtaining a grant or other form of finance. Those endeavours undertakings are easier to enforce because there is enough certainty about the object of the endeavours and the contemplated future agreement is just a means of achieving it.

Atalaya's endeavours undertaking fell into this second category but the court was not convinced by the *Dany Lions* distinction because entering into a contract with someone is never an end in itself but always a means of achieving a further object or purpose. The requirements of certainty of object and sufficient objective criteria are not always difficult to satisfy and there is no rule that they will not usually be satisfied where the object of an undertaking to use reasonable endeavours is an agreement with a third party. Where the parties have adopted at test of "reasonableness" they are deliberately inviting the court to make a value judgement which sets a limit to their freedom of action. It does not follow from the fact that there may often be difficulty of proof that there is no obligation at all. Atalaya's promise to use all reasonable endeavours to obtain a debt facility was enforceable – although, in fact, it had not been breached.

Conclusion

Contracting parties should think carefully about open-ended undertakings to use endeavours to reach agreement with each other or third parties. There seems to be no hard and fast rule that these undertakings are unenforceable on the grounds of uncertainty but it may be difficult to establish breach particularly where commercial judgments are concerned. For important endeavours undertakings it will help to ensure the provision is limited in time and spells out the consequences of failing to reach agreement by the long-stop date. Giving examples of the actual steps required should also help with enforceability.

2 *Dany Lions v Bristol Cars* [2014] EWHC

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