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THE PROHIBITION AGAINST FINANCIAL ASSISTANCE: CONSTRUCTING A RATIONAL RESPONSE

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1.1 Introduction

The prohibition against a company giving financial assistance for the acquisition of its own shares has generated considerable controversy since its inception in 1928.¹ Chief among the criticisms directed at the regime arise from its complexity and fitness for purpose. It was a topic which the recent Company Law Review (hereafter, the CLR) spent considerable time discussing, though ultimately the Second EC Company Law Directive² prevented wholesale revision of the rule notwithstanding the CLR's inclination towards its relaxation for both private and public companies.³ As a result, the Companies Act 2006 (hereafter, the 2006 Act) now restricts the prohibition to public companies only.⁴ Subject to certain exceptions, the broad

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¹ Companies Act 1928, s 16, re-enacted in the Companies Act 1929, s 45.

² See Directive 77/91/EEC, as amended by 2006/68/EC.

³ *Company Law for a Competitive Economy: The Strategic Framework* (URN 99/654) February 1999, para 5.4.25. The abolition of the prohibition on a private company providing financial assistance for an acquisition of its shares fell within the CLR's objective to simplify the law for private companies: see *Company Law for a Competitive Economy: Final Report*, July 2001 (DTI/Pub 5552/5k/7/01/NP), para 10.6. The CLR recognized that relaxing the prohibition for public companies would require a radical amendment to the Second Directive.

⁴ Until the 2006 Act the prohibition applied both to public and private companies, although in the case of the latter there was some relaxation by virtue of a 'whitewash' procedure (see Companies Act 1985, ss 151 and 155–8); see further, C Roberts, *Financial Assistance for the Acquisition of Shares* (OUP, 2005). On 1 October 2008 the prohibition applying to private companies was removed by the repeal of ss 155–8 and amendment to the remaining sections. The relevant 2006 Act provisions, contained in Part 18, Chapter 2, came into force on 1 October 2009. They lift the prohibition on private companies unless they are subsidiaries of public companies.

rule, laid down by s 678, prohibits a public company, or its subsidiary company, providing financial assistance to third parties for the purpose of acquiring shares in it. The criminal sanctions for breach are retained by s 680 of the 2006 Act.⁵

A particular problem which the prohibition was designed to address related to asset-stripping takeovers. The Greene Committee,⁶ the architect of the original statutory provision, gave the following example of the mischief which it reasoned required a legislative response:

A practice has made its appearance in recent years which we consider to be highly improper. A syndicate agrees to purchase from the existing shareholders sufficient shares to control a company, the purchase money is provided by a temporary loan from a bank for a day or two, the syndicate's nominees are appointed directors in place of the old board and immediately proceed to lend to the syndicate out of the company's funds (often without security) the money required to pay off the bank. Thus in effect the company provides money for the purchase of its own shares. This is a typical example although there are, of course, many variations.⁷

In modern parlance such an arrangement is referred to as a 'leveraged buyout' (LBO) which perhaps conveys a clearer indication that the acquisition is financed by debt.⁸

Apart from the criticisms levelled at the complexity of the statutory provisions and the absence of any clear rationale for the prohibition on financial assistance,⁹ its conventional location within the realms of capital maintenance and creditor protection,¹⁰

⁵ It was not until the Companies Act 1980 that breach could carry up to two years' imprisonment.

⁶ 'Report of the Company Law Amendment Committee 1925–26' (Cmnd 2657).

⁷ Ibid, para 30.

⁸ The term owes its origins to US terminology. In the UK such transactions are generally referred to as 'management buy-outs'.

⁹ In the *Final Report*, above n 3, para 2.30, the CLR, commenting on the relevant provisions in the Companies Act 1985, see above n 4, observed:

These provisions are among the most difficult of the Act, and in many cases it is all but impossible for a company to assess whether a proposed course of action is lawful or not. The provisions are arbitrary in their effect . . . and innocuous transactions may be rendered unlawful by criminal law requirements that are often unenforceable and by civil sanctions of wide and damaging effect.

See, further, C Roberts, *Financial Assistance for the Acquisition of Shares* (OUP, 2005), para 7.01; P Davies, *Gower and Davies' Principles of Modern Company Law* (8th edn, Sweet & Maxwell, 2008), paras 13–27; and E Ferran, 'Corporate Transactions and Financial Assistance: Shifting Policy Perceptions but Static Law' [2004] Cambridge Law Journal 225. See also the views expressed by Toulson LJ in *Anglo-Petroleum Ltd v TFB (Mortgages) Ltd* [2008] 1 BCLC 185 at 191. E Wymeersch has observed that 'the rule's rationale is far from clear', see 'Article 23 of the Second Company Law Directive: The Prohibition on Financial Assistance to Acquire Shares of the Company' in J Basedow, K J Hopt, and H Kötz (eds), *Festschrift für Ulrich Drobnig* (Mohr Siebeck 1998), 725 at 746.

¹⁰ See R Barham, 'Financial Assistance: Proposals for Reform' (1994) 5(2) International Company and Commercial Law Review 39, who describes capital maintenance as the 'principal objective of the financial assistance provisions'. See also, C Proctor, 'Financial Assistance: New Proposals and New Perspectives?' (2007) 28 Company Lawyer 3.

has also given rise to divergent views among reform bodies, commentators, and judges.¹¹ These mixed responses no doubt arise in part, at least, from the Greene Committee placing mixed emphasis on what it saw as the principal wrongs generated by financial assistance. The Committee clearly thought that if financial assistance was permitted, or at least tolerated, it would militate against creditor and shareholder protection; factors long identified as the central policy concerns underlying the maintenance of capital doctrine.¹² Further, although the subject of financial assistance fell within Part B, 'Share Capital', of the Report and has since been dealt with in a like manner by others, including commentators,¹³ it seems clear that even in the particular example put forward by the Committee itself, the loan given by the company does not, in fact, impact on its share capital.¹⁴ As pointed out by the CLR, even if financial assistance were to prejudice creditors by reducing the company's net assets,

that is true of any unwise handling of corporate assets. Other transactions, including payment of dividends, or even ordinary trading transactions, may also reduce a company's assets and adversely affect its ability to repay creditors.¹⁵

Perhaps not surprisingly, therefore, there is a consensus of opinion that the prohibition is drawn far too widely and, as a consequence, it renders unlawful what would otherwise be harmless and profitable commercial transactions for companies.¹⁶

This chapter is in three sections. Section 1.2 first outlines the historical development of the prohibition on the giving of financial assistance and considers, in outline, its principal policy objectives as they evolved throughout much of the twentieth century. Emphasis will be given to the early jurisprudence which shaped the scope of the rule. Secondly, beginning with the relevant provisions of the

¹¹ See eg the 'Report of the Company Law Committee' (Cmnd 1749, 1962), paras 170–87, (the Jenkins Committee) which questioned the link between capital maintenance and the financial assistance prohibition. See also, E Ferran, *Principles of Corporate Finance Law* (OUP, 2008), 272–5; and E Ferran, 'Creditors' Interests and "Core" Company Law' (1999) 20 Co Law 314 at 319, pointing out that an alternative explanation for the prohibition may well be the prevention of 'market manipulation'. The author cites Kirby P's judgment in *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 15 ACLR 230 (NSWCA) at 256, who noted that the purposes of the prohibition 'include the avoidance of the manipulation of the value of shares by companies and their officers dealing in such shares'. See further, J Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) 63 MLR 355 at 368–70.

¹² See *Trevor v Whitworth* (1887) 12 App Case 409 (HL), discussed below at n 17, and associated text. See the Greene Committee Report, above n 6, para 30.

¹³ In its examination of the prohibition, the CLR noted its conventional location within the capital maintenance regime, see *The Strategic Framework*, above n 3, para 5.4.20.

¹⁴ See *Modern Company Law For a Competitive Economy: Company Formation and Capital Maintenance* ((URN 99/1145) October 1999), para 3.41.

¹⁵ *Modern Company Law for a Competitive Economy: Developing the Framework* ((URN 00/656) March 2000), para 7.21.

¹⁶ See *Developing the Framework*, *ibid*, para 7.19. See also, the *Final Report*, above n 3, para 2.30. See further, J Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', above n 11, at 368–70.

Companies Act 1985 which have been largely carried over into the 2006 Act, Section 1.3 discusses the current regime with particular reference to the development of the 'commercial realities' test in the recent case law. It will be seen that the modern judges have enlisted the test as a means of narrowing the ambit of the prohibition. It is also argued that notwithstanding the constraints of the Second EC Directive, the CLR missed an opportunity in not clarifying the considerable uncertainties surrounding the prohibition which resulted from decisions in which, for example, the principal purpose exception has been at issue. Finally, Section 1.4 concludes by assessing whether the English common law holds the potential to provide adequate protection to the company, its shareholders, and creditors were the prohibition to be abolished, as has occurred in other jurisdictions.

1.2 The Origins, Development, and Policy Objectives of the Prohibition

In tracing the genesis of the prohibition, the starting point is the decision in *Trevor v Whitworth*,¹⁷ in which the House of Lords laid down the rule making it unlawful for a company to use its assets to purchase its own shares. Here the memorandum of association did not authorize the company to purchase its shares, however, the company's articles contained a provision stating that '[a]ny share may be purchased by the company from any person willing to sell it, and at such price, not exceeding the then market value thereof, as the board think reasonable'.¹⁸ When the company went into liquidation in 1884, a claim was brought against it by the executors of Whitworth, a deceased shareholder, for the balance of the price of his shares sold by the executors to the company in 1880. The liquidators sought to determine whether the claim ought to be allowed. In formulating the rule, it is clear from the reasoning of the House of Lords that they took the view that it should be anchored firmly within the realm of creditor protection and, as such, arose as an inevitable consequence of the limited liability principle.¹⁹ Lord Herschell, surveying the nature of the limited liability company and the statutory provisions then governing reduction of capital, explained that a company's capital:

may, no doubt, be diminished by expenditure upon and reasonably incidental to all the objects specified [in the memorandum]. A part of it may be lost in carrying on the business operations authorised. Of this all persons trusting the company are aware, and take the risk. But I think they have a right to rely, and were intended by the Legislature to have a right to rely, on the capital remaining undiminished by any expenditure outside these limits, or by the return of any part of it to the shareholders . . .

¹⁷ Above n 12. Overruling *Re Dronfield Silkstone Coal Co* (1880) 17 ChD 76.

¹⁸ Reg 179 of the articles of association.

¹⁹ Introduced by the Limited Liability Act 1855.

If the claim under consideration can be supported, the result would seem to be this, that the whole of the shareholders, with the exception of those holding seven individual shares, might now be claiming payment of the sums paid upon their shares as creditors, who had a right to look to the moneys subscribed as the source out of which the company's liabilities to them were to be met. And the stringent precautions to prevent the reduction of the capital of a limited company, without due notice and judicial sanction, would be idle if the company might purchase its own shares wholesale . . .²⁰

Lord Watson agreed, noting that those who extend credit to a company rely on the fact that it is trading with a certain sum of capital already paid and 'they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business'.²¹

It is clear that the House of Lords was primarily concerned with protecting the company's capital for the benefit of its creditors while recognizing that this objective is always subject, of course, to its diminution through the risks of ordinary trading.²² It was against this jurisprudential background that the Greene Committee concluded that a company should be barred from assisting financially in the acquisition of its shares.²³ Although the Committee did not expressly rely on the reasoning in *Trevor v Whitworth*, there is a suggestion that the prohibition was seen as an extension of the decision insofar as in formulating its recommendation the Greene Committee drew directly from the language of Lord Herschell. His Lordship, discussing the nature of the transaction in issue, concluded that it amounted to the company 'trafficking in its shares'.²⁴ As seen above, having identified the mischief to be addressed by the prohibition, the Greene Committee concluded that:

Such an arrangement appears to us to offend against the spirit if not the letter of the law which prohibits a company from *trafficking in its own shares* and the practice is open to the gravest abuses . . .²⁵

The statutory prohibition against the giving of financial assistance followed closely on the heels of the Greene Committee's recommendations. It was enacted by the Companies Act 1928, s 16 which was, in turn, re-enacted by the Companies Act 1929, s 45. This made it unlawful

for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase made or to be made by any person of any shares in the company.

²⁰ Above n 12, at 415.

²¹ Ibid at 424

²² See also, *Wallersteiner v Moir* [1974] 1 WLR 991, especially Scarman LJ's judgment at 1033.

²³ See further, G R Bretten, 'Financial Assistance in Share Transactions' [1968] Conv 6.

²⁴ Above n 12, at 417, citing James LJ in *Teasdale's Case* Law Rep 9 Ch 54.

²⁵ Above n 6 (emphasis added).

The early provisions had a chequered history insofar as they have been the subject of a range of amendments over the ensuing years to address drafting defects identified in a number of decisions. A problem which became apparent with the drafting of the original offence in s 45 of the 1929 Act was the absence of any reference to the acquisition of shares by 'subscription'. In *Re VGM Holdings Ltd*,²⁶ where the action arose by way of a misfeasance summons against the directors of VGM, the Court of Appeal, holding the arrangement at issue to be a subscription, found that this was necessarily without the scope of the statutory language. Lord Greene MR, delivering the principal judgment, reasoned that

the word 'purchase' in section 45 cannot with propriety be applied to a legal transaction under which a person, by the machinery of application and allotment, becomes a shareholder in the company. He does not purchase anything when he does that.²⁷

His earlier comments in the case are of particular interest given that he had chaired the committee which had recommended the introduction of the statutory prohibition. He said:

Those whose memories enable them to recall what had been happening after the last war [viz that of 1914–18] for several years will remember that a very common form of transaction in connection with companies was one by which persons—call them financiers, speculators, or what you will—finding a company with a substantial cash balance or easily realizable assets such as war loans, bought up the whole or the greater part of the shares of the company for cash and so arranged matters that the purchase money which they then became bound to provide was advanced to them by the company whose shares they were acquiring, either out of its cash balance or by realization of its liquid investments. That type of transaction was a common one, and it gave rise to great dissatisfaction and, in some cases, great scandals. I think that it is not illegitimate to bear in mind that notorious practice in considering the ambit of the section. I do not mean by this that, if the language of the section is wide enough to extend beyond transactions of that general character, that would afford any ground for cutting the language down. The only use which I think it is legitimate to make of it is that the existence of this very questionable practice affords a reason for the word 'purchase' in the section. If, as a matter of construction, 'purchase' extends to cases such as the present where the money is used not in connection with the purchase of the company's shares but in connection with the subscription for the company's shares, that construction must be put on the language.²⁸

²⁶ [1942] Ch 235, CA.

²⁷ Ibid at 240. In so finding, Lord Greene MR rejected counsel's argument that a share before issue was an existing article of property and as such was an existing bundle of rights which a shareholder could properly be said to be purchasing when acquired by subscription. His Lordship confirmed that a share is a chose in action. He explained, at 241, that:

a chose in action implies the existence of some person entitled to the rights which are rights in action as distinct from rights in possession, and, until the share is issued, no such person exists.

²⁸ Ibid at 239–40.

Following a recommendation of the next major review of company law undertaken by the Cohen Committee,²⁹ the legislature responded by inserting the term ‘subscription’ into the next companies’ statute,³⁰ namely, s 54 of the Companies Act 1948, which stated:

subject as provided in this section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a *purchase or subscription* made or to be made by any person of or for any shares in the company, or, where the company is a subsidiary company, in its holding company . . .³¹

It is noteworthy that the provision also extended the prohibition to a subsidiary company providing financial assistance for the purchase of, or subscription for, shares in its holding company and in so doing was no doubt responding to a perceived loophole in the law.

Just over thirty years after the prohibition was first enacted it was subjected to extensive reconsideration by the Jenkins Committee which reported in 1962.³² The view was taken that financial assistance did not necessarily offend the rule that a limited company may not buy its own shares.³³ The reason why a company is forbidden from entering into such a transaction is that in so doing it would part outright with the consideration for the purchase and thereby reduce its capital. The Committee noted that where a company lends money to a person to buy its shares, it simply changes the form of its assets and if the borrower is in a position to repay the loan the company’s capital remains intact. If the assurance given to the purchaser is improper and the company suffers loss, the directors who are parties to the transaction will be liable for misfeasance. Interestingly, the Committee stressed that the purpose underlying the statutory prohibition is aimed at preventing abuses which inevitably arise when such arrangements are made. It concluded that if purchasers who cannot provide the finance necessary to acquire control of a company from their own resources, or raise the necessary credit themselves to finance the transaction, gain control of a company with large assets on the basis that they will use the funds of the company to pay for their shares then ‘it seems to us all too likely

²⁹ ‘Report of the Committee on Company Law Amendment’ (Cmd 6659, 1945), para 170. For comment on the Committee’s recommendations, see M Murphy, ‘Revision of British Company Law’ (1946) 36 *American Economic Review* 659.

³⁰ This was no doubt intended to negate the loophole created by the decision in *Re VGM Holdings Ltd*, though the Cohen Committee gave no reasons for the recommendation.

³¹ Emphasis added.

³² Above n 11.

³³ *Ibid* at para 173. In this regard the Committee concluded that had s 54 of the 1948 Act been designed merely to extend that rule, ‘we should have felt some doubt whether it was worth retaining’.

that in many cases the company will be made to part with its funds either on inadequate security or for an illusory consideration'.³⁴ Accordingly:

If the speculation succeeds, the company and therefore its creditors and minority shareholders may suffer no loss . . . if it fails, it may be little consolation for creditors and minority shareholders to know that the directors are liable for misfeasance . . .³⁵

The Committee therefore took the view that the true rationale underlying the prohibition was not the need to maintain capital, but rather the potential dangers which indebted acquirers might pose to company creditors. It therefore recommended that the statutory prohibition should be retained and strengthened. It is noteworthy that the emphasis here is on preventing abuse rather than on the need to maintain capital. A further problem the Committee identified was that all too often the company's remedies against the acquirer proved worthless, either because he has disappeared, or has disposed of his assets, or is insolvent and minority shareholders and creditors suffer accordingly.³⁶

Problems continued to arise with the drafting of s 54 which were left to the courts to resolve. It was not too long after the Jenkins Committee published its final report that it became apparent that the provision held the potential to lead to the perverse result that the company would not be able to recover the money advanced to fund the illegal transaction of assisting in the purchase of its own shares because it was a party to the illegal contract. This apparent absurdity came to the fore in *Selangor United Rubber Estates Ltd v Cradock (No 3)*,³⁷ where two nominee directors, L and J, caused the company to provide finance to Cradock so as to enable him to purchase all of its shares. Ungood-Thomas J reasoned that the company was an involuntary party to the illegal transaction which it entered into as a result of the breach of duty by its directors. Accordingly the directors, L and J, were liable to reimburse the company the money paid by it unlawfully.³⁸ In this regard, it is noteworthy that the court, in considering the prohibition and the maintenance of capital principle, focused principally on the conduct of the directors as amounting to a breach of their fiduciary duties. Further, the decision established unlimited liability on the basis of constructive trusteeship for banks and other third parties who unintentionally participate in arrangements that breach the prohibition. Liability does not end there. If a transaction is unlawful, those who participate in its

³⁴ Ibid.

³⁵ Ibid.

³⁶ Ibid at para 176.

³⁷ [1968] 1 WLR 1555.

³⁸ The judge concluded, at 1652, citing *Steen v Law* [1964] AC 287:

The plaintiff's claim . . . for breach of trust is not made by it as a party to that transaction, or in reliance on any right which that transaction is alleged to confer, but against the directors and constructive trustees for perpetrating that transaction and making the plaintiff company party to it in breach of trust owing to the plaintiff company.

implementation can be made liable in damages for conspiracy.³⁹ The class of participants here will be wider than that caught by constructive trusteeship or by misfeasance proceedings. All in all, the decision marks a particularly significant increase in liability, given that under s 442(1) of the 1948 Act the criminal penalty for breach was limited to the risk of a fine on the company and any of its officers in default (but no other party) not exceeding £100.⁴⁰

The breadth of the prohibition was given a significant and unfortunate boost by the Court of Appeal in *Belmont Finance Corporation v Williams Furniture Ltd (No 2)*,⁴¹ a decision which has attracted much critical comment.⁴² The company purchased an asset for a grossly inflated price and the vendors subsequently used the proceeds of the sale to buy the company. Overturning the decision of the trial judge, it was held that the transaction amounted to financial assistance on the basis that the company had acted without regard to its own commercial interests and with the objective of facilitating the vendor's acquisition of its shares.⁴³ Three reserved judgments were delivered. Buckley LJ, with whom Goff LJ agreed, expressed the view that where the sole purpose of the arrangement was to put the third party in funds in order to acquire the shares, this clearly amounted to financial assistance. He went on to add that it might also have contravened the prohibition where putting the vendor in funds to acquire the company's shares was merely one of a number of purposes. However, he went on to state that he did not wish to express a concluded opinion on the point.⁴⁴ Waller LJ, on the other hand, took a stricter view. He thought the prohibition would actually be infringed in such a case:

To avoid a contravention of s 54 it is not sufficient, in my view, to show that the company is purchasing an asset which is worth the price being paid. The company must also show that the decision to purchase is made in the commercial interests of the company. If this were so, then the fact that the proceeds are used by the seller for the purchase of shares in the company would not necessarily infringe s 54. That would only happen if the decision was made partly with the intention on the part of the board that the proceeds should be used for the purchase of shares in the company.⁴⁵

³⁹ *Tweed Co Ltd v Crofter Hand Woven Harris Veitch* [1942] AC 435 at 440. For a detailed analysis of this part of the decision, see R Instone, 'Section 54 and All That' [1980] JBL 99. See generally, R Stevens, *Torts and Rights* (OUP, 2007), chs 11 and 12. In *Belmont Finance Corporation v Williams Furniture Ltd (No 2)* [1980] 1 All ER 393, discussed below, the Court of Appeal held the parties guilty of conspiracy on the basis that they had together agreed to do an unlawful act, viz provide financial assistance in contravention of s 54 of the 1948 Act.

⁴⁰ The 11th edition of *Buckley on the Companies Acts* (Butterworths, 1930) noted the inadequacy of the criminal penalty as a deterrence given 'the scale upon which such transactions are framed'. The current position is laid down by s 680 of the 2006 Act, discussed below.

⁴¹ [1980] 1 All ER 393.

⁴² See eg R Instone, 'Section 54 and All That' [1980] JBL 99 at 105–8.

⁴³ See, in particular, the judgment of Buckley LJ, at 403, who explained that 'It was an exceptional and artificial transaction and not in any sense an ordinary commercial transaction entered into for its own sake in the commercial interests of Belmont.'

⁴⁴ Above n 41, at 401.

⁴⁵ Above n 40, at 414.

Waller LJ thus views the scope of the prohibition as extending to cover transactions, even if for fair value, where the provision of financial assistance was made ‘partly with the intention’ that it should be applied to acquire the company’s shares, notwithstanding that it would otherwise be in the commercial interests of the company.⁴⁶ Commenting on the Court of Appeal’s reasoning, Hoffmann J (as he then was) observed that:

The *Belmont* case shows that the sale of an asset by the company at a fair value can properly be described as giving financial assistance if the effect is to provide the purchaser of its shares with the cash needed to pay for them. It does not matter that the company’s balance sheet is undisturbed in the sense that the cash paid out is replaced by an asset of equivalent value. In the case of a loan by a company to a creditworthy purchaser of its shares, the balance sheet is equally undisturbed but the loan plainly constitutes giving financial assistance. It follows that if the only or main purpose of such a transaction is to enable the purchaser to buy the shares, the section is contravened.⁴⁷

The judge’s reference to the ‘only or main purpose of such a transaction’ might, at face value at least, be viewed as indicative of a measure of agreement with the more restrictive approach of Buckley and Goff LJ as opposed to the rather more open-textured view of the prohibition taken by Waller LJ. Support for greater pragmatism can also be gleaned from the warning expressed by Hoffmann J earlier in his judgment in *Charterhouse Investments Trust Ltd v Tempest Diesels Ltd* to the effect that:

One must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance by the company, bearing in mind that the section is a penal one and should not be stretched to cover transactions which are not fairly within it.⁴⁸

Overall, the decision in *Belmont* was unexpected. The general view amongst practitioners of the time was that if the transaction was concluded at a fair price and was capable of justification on purely commercial grounds and was bona fide, it would not contravene the prohibition.⁴⁹ Indeed, the trial judge in the case, Foster J, treated as a proposition of law that a company does not give financial assistance in connection with a purchase of its own shares by reason only of its simultaneous entry into a bona fide commercial transaction as a result of which it parts with money or money’s worth, which in turn is used to finance the purchase of its own shares.⁵⁰

⁴⁶ Discussed in (1980) 1 Co Law 99. See also, *Armour Hick Northern Ltd v Whitehouse* [1980] 1 WLR 1520.

⁴⁷ *Charterhouse Investments Trust Ltd v Tempest Diesels Ltd* [1986] BCLC 1 at 10.

⁴⁸ Ibid. A similar approach was advocated by Lord Denning in *Wallersteiner v Moir* [1974] 1 WLR 991 at 1012, when considering financial assistance in the context of takeovers where the target company’s assets are used to assist the bidder:

The transactions are extremely complicated, but the end result is clear. You look to the company’s money and see what has become of it. You look to the company’s shares and see into whose hands they have got. You will then soon see if the company’s money has been used to finance the purchase.

⁴⁹ See R Instone, above n 39, at 108.

⁵⁰ Above n 41, at 402, as noted by Buckley LJ.

1.3 The Current Regime

1.3.1 Background

The Second EC Company Law Directive,⁵¹ Art 23, provides that ‘a [public] company may not advance funds, nor make loans, nor provide security with a view to the acquisition of its shares by a third party’. The Directive therefore restricts what, at the minimum, Member States may provide in domestic legislation with respect to public companies, and it was against this backdrop that the provisions dealing with financial assistance contained in the 1980s legislation were cast.

In the light of the uncertainties surrounding the scope of s 54, the provision was repealed and replaced by the Companies Act 1981. The provisions therein were re-enacted, with minor amendments, by the Companies Act 1985, ss 151 to 154. It was these sections, together with the Second EC Directive, which confronted the CLR at its launch.⁵² It will be seen that as far as public companies are concerned, the prohibition was left largely untouched by the 2006 Act. As commented above, the Second Directive imposed a straitjacket on the CLR in terms of wholesale reform of the prohibition. But the CLR missed the opportunity to at least address the complexity of the case law which had grown up around the 1985 Act provisions. This is a significant omission in light of the policy objectives of the CLR of constructing a company law regime founded upon the twin axioms of ‘simplification and accessibility’.⁵³

The general prohibition against providing financial assistance (which applied to both private and public companies) was laid down by s 151(1) of the 1985 Act. It provided:

Subject to the following provisions of this Chapter, where a person is acquiring or proposing to acquire shares in a company, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of the acquisition before or at the same time as the acquisition takes place.

This is re-enacted, with amendments, by the 2006 Act, ss 678(1) and 679(1). The prohibition also extends to post-acquisition assistance.⁵⁴ The principal change,

⁵¹ EEC 77/91 (OJ L26/1 31.1.1977).

⁵² See *Company Law for a Competitive Economy*, March 1998 (DTI/Pub 3162/6.3k/3/98/NP).

⁵³ *Final Report*, above n 3, para 1.54. After all, in framing the restatement of directors’ duties in the Companies Act 2006, Part 10, the CLR used the process as an opportunity to correct defects in the law: see *Final Report*, para 3.7. On this basis, the CLR might have proposed that the relevant statutory provisions on financial assistance be substantially reformulated as a means of addressing the complexities of decisions such as *Brady v Brady* [1989] AC 755. This would at least have made the law on ‘principal purpose’ more readily comprehensible; as to which, see nn 70–4, and associated text, below.

⁵⁴ s 151(2) of the 1985 Act, re-enacted with drafting amendments by s 678(3) of the 2006 Act.

as commented above,⁵⁵ is that the prohibition on private companies providing financial assistance is not carried forward.⁵⁶ Section 152(1)(a) of the 1985 Act provided a very wide definition of financial assistance which is adopted by the 2006 Act.⁵⁷ It includes, amongst other things, financial assistance given by way of gift, guarantee,⁵⁸ security, or indemnity (other than an indemnity in respect of the indemnifier's own neglect or default), or by way of release or waiver, or by way of a loan. The definition is reinforced by the addition of the following phrase: 'or any other financial assistance given by a company the net assets of which are thereby reduced to a material extent or which has no net assets'.⁵⁹

1.3.2 The meaning of financial assistance

The meaning of financial assistance and, more particularly, the term 'purpose' found both in s 151(1) of the 1985 Act and its progeny in the 2006 Act has been considered in a number of modern decisions. For example, in *Chaston v SWP Group plc*,⁶⁰ a subsidiary company paid some £20,000 in respect of professional fees arising in relation to a due diligence report on its parent company which was required for the purpose of a takeover of the parent company by a third party. The Court of Appeal held that this amounted to financial assistance. Arden LJ, citing Hoffmann J's observations in *Charterhouse v Tempest Diesels*,⁶¹ concluded that the determining factor is the 'commercial substance' of the transaction: as a matter of commercial reality, the fees in question 'smoothed the path to the acquisition of shares'.⁶² Although the Jenkins Committee took the view that it was unwise to attempt a precise definition of financial assistance,⁶³ the modern courts are nevertheless seeking to set some limits around the scope of the prohibition.⁶⁴ This is to be

⁵⁵ See n 4 above.

⁵⁶ That said, the 1985 Act did relax the prohibition for private companies where the so-called 'whitewash' procedure had been complied with, see n 4 above.

⁵⁷ See ss 677 and 683(2) of the 2006 Act.

⁵⁸ The giving of a security within s 152(1)(a)(ii) is illustrated by the facts of *Heald v O'Connor* [1971] 1 WLR 497. Mr and Mrs Heald sold all of the shares in D E Heald (Stoke on Trent) Ltd to O'Connor. The price was £35,000 but they lent him £25,000 in order to enable him to complete the purchase. The company thereby granted the vendors a floating charge over all its assets by way of security for the loan. If O'Connor defaulted, the security would be enforceable against the company. Fisher J held that the security was given in breach of the prohibition and was void.

⁵⁹ s 152(1)(a)(iv) of the 1985 Act, now s 677(1)(d) of the 2006 Act.

⁶⁰ [2003] 1 BCLC 675. See also, *Corporate Development Partners LLC v E-Relationship Marketing Ltd* [2007] EWHC 436.

⁶¹ See nn 47–8, above and associated text. Lord Hoffmann's approach to the determination of financial assistance has been approved by the Court of Appeal in *Barclays Bank plc v British and Commonwealth Holdings plc* [1996] 1 BCLC 1.

⁶² Above n 60, at [38].

⁶³ Above n 11, para 180.

⁶⁴ In *Chaston* Arden LJ, above n 60, at [31], reasoned that the principal mischief that the prohibition seeks to address is

that the resources of the target company and its subsidiaries should not be used directly or indirectly to assist the purchaser financially to make the acquisition. This may prejudice the

welcomed not only because it furthers the interests of achieving commercial certainty but also because, as acknowledged by Hoffmann J (as he was then) in *Charterhouse Investment Trust Ltd* in which he subjected the decision in *Belmont* to considerable scrutiny, he emphasized that because the provision is penal in nature, it should not be strained to cover transactions which are not fairly within it.⁶⁵

The focus on commercial realities has practical advantages where the alleged breach of the prohibition involves neither a net transfer of value nor the provision of liquidity as, for example, would be the case where a loan or a security for a loan is advanced. In finding that the prohibition had not been breached in *MT Realisations Ltd v Digital Equipment Co Ltd*,⁶⁶ the Court of Appeal narrowed the practical impact of the prohibition notwithstanding Arden LJ's more robust approach towards maintaining the breadth of its scope in *Chaston v SWP*.⁶⁷ The issue in the case arose out of a subsidiary company (MTR) paying sums owed under a secured loan to its parent company. These sums were used by the parent company to discharge its liability incurred in acquiring its shares in the subsidiary. In fact, MTR paid the sums directly to the vendor of the shares. In structuring the arrangement this way, there was an appearance of MTR's funds being used to pay liabilities arising on the acquisition of its shares. An action was brought on the basis that this amounted to financial assistance. Mummery LJ, delivering the principal judgment, reasoned that on the commercial realities of the transaction, financial assistance had *not* been given by MTR 'for the purpose of' reducing or discharging a liability incurred for the purpose of the acquisition of its shares. The parent company did not receive anything beyond what it was legally entitled to as secured creditor and structuring the arrangement so that the sums in question were paid directly to the vendor was done merely for commercial convenience.⁶⁸

interests of the creditors of the target or its group, and the interests of any shareholders who do not accept the offer to acquire their shares or to whom the offer is not made.

⁶⁵ Above n 47, at 10:

There is no definition of giving financial assistance in the section, although some examples are given. The words have no technical meaning and their frame of reference is in my judgment the language of ordinary commerce. One must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance by the company, bearing in mind that the section is a penal one and should not be strained to cover transactions which are not fairly within it.

See also, the comments of Toulson LJ in *Anglo Petroleum Ltd v TFB Mortgages*, above n 9, at 191.

⁶⁶ [2003] 2 BCLC 117.

⁶⁷ For an excellent analysis of these two recent decisions, see E Ferran, 'Corporate Transactions and Financial Assistance: Shifting Policy Perceptions and Static Law' [2004] CLJ 225.

⁶⁸ See also, *Anglo Petroleum Ltd v TFB (Mortgages) Ltd*, above n 9, in which one of the issues concerned whether the payment of outstanding debts to a parent company constituted financial assistance. The Court of Appeal, finding that there were bona fide reasons for the repayment, held that the prohibition had not been breached. Toulson LJ reasoned that what matters is not how the money was obtained, but the use made of it by the company.

A further advantage of the 'commercial realities' test is that it gives the courts scope to adopt a pragmatic approach towards the determination of whether the prohibition has in fact been breached or, on the other hand, whether it is being enlisted by a party in order to achieve some collateral purpose, such as having an onerous transaction which was freely entered into set aside on the ground of illegality. For example, in *Dymment v Boyden*,⁶⁹ the applicant and the two respondents were partners in a residential nursing home, the freehold of which was owned by each in equal shares. The home was run through a company of which the partners were directors. When one of the respondents was charged with assault the local authority cancelled the nursing home's registration under the Registered Homes Act 1984. As a result, the partnership was dissolved by agreement whereby the respondents transferred their shares in the company to the applicant in return for which she transferred her interest in the freehold to the respondents. They then granted a lease of the property to the company at a rent considerably in excess of its market value. The applicant, clearly unhappy with the excessive rent she was paying, argued that to the extent the rent exceeded the market value, the difference represented financial assistance since it resulted in the company's net assets being reduced. Further, because that assistance had been given to facilitate the acquisition by the applicant of the respondents' shares it had been given either 'directly or indirectly' for the purposes of that acquisition. The Court of Appeal held that the trial judge was right in finding that the company's entry into the lease was 'in connection with' the acquisition by the appellant of the shares but was not 'for the purpose of' that acquisition. His finding that the entry into the lease was for the purpose of acquiring the premises rather than the shares was a finding of fact with which the Court of Appeal should not interfere.

1.3.3 The exceptions to the prohibition

Exceptions to the prohibition were listed in s 153 which is now re-enacted, with amendments, by the 2006 Act, ss 678–9 and 681–2. Of particular interest is the 'principal purpose' defence which was laid down by s 153 of the 1985 Act and is now found in s 678(2) and (4) together with s 679(2) and (4) of the 2006 Act. Broadly speaking, financial assistance is permitted where:

- (a) the company's principal purpose in giving that assistance is not to give it for the purpose of any such acquisition, or the giving of the assistance for that purpose is but an incidental part of some larger purpose of the company; or
- (b) the company's principal purpose in giving that assistance is not to reduce or discharge any liability incurred by a person for the purpose of the acquisition of shares in the company or its holding company, or the reduction or discharge of any liability is but an incidental part of some larger purpose of the company;

⁶⁹ [2005] 1 WLR 792.

and, in either case, the assistance is given in good faith in the interests of the company.

Although the exceptions are aimed at ensuring that the prohibition does not catch genuine commercial transactions which are in the interests of the company, attempting to assess a person's 'purpose' is a nebulous exercise (for instance, the need to distinguish purpose from effect) because the court will need to determine, for example, whether the giving of assistance for *the purpose* of an acquisition of shares is an incidental part of some larger purpose. These difficulties came to the fore in *Brady v Brady*,⁷⁰ a notoriously difficult decision which has been left untouched by the 2006 Act notwithstanding the CLR's recommendation that 'predominant reason' should replace 'principal purpose'.⁷¹

The scheme in issue in *Brady* involved a company's business being divided between two brothers, Jack (J) and Bob (B) who were the controlling shareholders. They were not on speaking terms and the deadlock between them threatened the survival of the company and its subsidiaries. It was decided that J should take the haulage business and B the soft drinks business. However, the haulage business was worth more than the soft drinks business and so to make the division fair and equal, extra assets had to be transferred from the haulage business to the drinks business. In essence this involved the principal company, Brady, transferring assets to a new company controlled by B. It was conceded that the prohibition had been breached because the transfer involved Brady providing financial assistance towards discharging the liability of its holding company, M, for the price of shares which M had purchased in Brady. When J sought specific performance of the agreement, B contended that it was an illegal transaction. J argued, however, that the financial assistance was but an incidental part of a larger purpose of the company, that is, the removal of deadlock between the two brothers which had threatened to result in the liquidation of the business. The House of Lords construed the principal purpose provision very narrowly,⁷² drawing a distinction between a 'purpose' and the 'reason' why a purpose is sought. Lord Oliver, interpreting the phrase 'larger purpose', explained that:

there has always to be borne in mind the mischief against which section 151 is aimed. In particular, if the section is not, effectively, to be deprived of any useful application, it is important to distinguish between a purpose and the reason why a purpose is formed. The ultimate reason for forming the purpose of financing an acquisition may, and in most cases probably will, be more important to those making the decision than the immediate transaction itself. But 'larger' is not the same thing as 'more important' nor is 'reason' the same as 'purpose'. If one postulates the case of a bidder for control

⁷⁰ [1989] AC 755.

⁷¹ *Company Formation and Capital Maintenance* (URN 99/1145), October 1999, para 3.42. See the debates on the issue in the House of Lords: Hansard, vol 682, col 182 (16 May 2006).

⁷² At the time of the decision, it was s 153 of the Companies Act 1985.

of a public company financing his bid from the company's own funds—the obvious mischief at which the section is aimed—the immediate purpose which it is sought to achieve is that of completing the purchase and vesting control of the company in the bidder. The reasons why that course is considered desirable may be many and varied. The company may have fallen on hard times so that a change of management is considered necessary to avert disaster. It may merely be thought, and no doubt would be thought by the purchaser and the directors whom he nominates once he has control, that the business of the company will be more profitable under his management than it was heretofore. These may be excellent reasons but they cannot, in my judgment, constitute a 'larger purpose' of which the provision of assistance is merely an incident. The purpose and the only purpose of the financial assistance is and remains that of enabling the shares to be acquired and the financial or commercial advantages flowing from the acquisition, whilst they may form the reason for forming the purpose of providing assistance, are a by-product of it rather than an independent purpose of which the assistance can properly be considered to be an incident.⁷³

The House of Lords therefore held that the purpose of the transaction was to assist in financing the acquisition of the shares. The essence of the reorganization was for J to acquire B Ltd's shares and therefore the acquisition of those shares was not incidental to the reorganization. As Lord Oliver concluded, the acquisition 'was not a mere incident of the scheme devised to break the deadlock. It was the essence of the scheme itself and the object which the scheme set out to achieve.'⁷⁴ However, Lord Oliver went on to hold that if B Ltd, which was solvent, complied with the whitewash procedure available to private companies under the 1985 Act,⁷⁵ the transaction would not be illegal. In seeking to maintain the effectiveness of the statutory prohibition in its construction of the principal purpose exception, the House of Lords effectively negated the practical application of the defence.

1.3.4 The consequences of breaching the prohibition

As was the case under the previous legislation, breach of the prohibition is made a criminal offence by the Companies Act 2006, s 680, which provides that an offence is committed by the company and every officer of the company who is in default. The imposition of criminal liability on the company seems curious given that the prohibition is directed towards protecting the company against the disposal of its assets. However, the point is made in the Explanatory Notes to the 2006 Act that:

The general principle adopted as to whether a company should be liable for a breach of requirements of the Companies Acts is that where the only victims of the offence are the company or its members, the company should not be liable for the offence. On the other hand, where other persons may be victims of the offence, then the company

⁷³ Above n 70, at 779–80.

⁷⁴ Ibid at 780.

⁷⁵ See n 4 above.

should be potentially liable for a breach, whether or not the offence may also harm the company or its members.⁷⁶

That said, this appears to be of little real importance given the absence of prosecutions for this particular offence although, admittedly, this may stand as proof of its value as a deterrent.⁷⁷ Of greater practical significance, however, are the civil consequences of entering into such an unlawful transaction.⁷⁸ These are left to the common law. If the financial assistance has not yet been given, the agreement cannot be specifically enforced.⁷⁹ If, however, unlawful financial assistance has been given by the company, the transaction is void and unenforceable.⁸⁰ This means that if it consists of an agreement, for instance a guarantee or a mortgage, the recipient of the financial assistance cannot enforce it.⁸¹ If the assistance took the form of a payment by the company, for example it was a gift or a loan, the company will have to sue to recover it. The basis of the claim will depend on who was the recipient. A director might be sued for breach of fiduciary duty or misfeasance while a third party might be sued as constructive trustee.⁸²

⁷⁶ Explanatory Notes to Companies Act 2006, para 1435: <http://www.opsi.gov.uk/acts/acts2006/en/ukpgaen_20060046_en_1> (last accessed 13 July 2010).

⁷⁷ As Reisberg notes, albeit in the context of the derivative claim:

it is virtually impossible to identify a general deterrent effect. This is because the precise effect of deterrence is virtually incalculable or at least not readily quantifiable. Two major factors combine to create this effect. First, evidence here is virtually non-existent, because general deterrence is not easily or readily susceptible to empirical testing. We cannot estimate the number of offences and thereby estimate the probability of detection, which is essential for measuring such an effect. . . . Secondly, the deterrence factor lies in the subjective, subconscious reactions of directors and thus is almost untraceable.

See A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) at 60. The same point holds true in relation to the impact of the wrongful trading and fraudulent trading provisions in the Insolvency Act 1986. See J Lowry and A Reisberg, *Pettet's Company Law* (3rd edn, Longman, 2009) at 41–5.

⁷⁸ An area which has, in the past, given rise to problems. As noted by L Sealy and S Worthington in *Cases and Materials in Company Law* (8th edn, OUP, 2008) at 410, the current provision now found in s 678 of the 2006 Act provides, as did its predecessors, that it is illegal for the company or its subsidiary to *give* financial assistance rather than making it illegal for the purchaser to *accept* financial assistance. This somewhat odd drafting anomaly led some judges in the past to the view that the object was not to protect the company, but rather to punish it. For example, in *Victory Battery Co Ltd v Curry's Ltd* [1946] Ch 242, a decision long criticized and now discredited, the issue was whether Victor Battery Ltd was entitled to a declaration that the debenture which it had issued to a nominee for Curry's was void on the basis it breached the prohibition. Roxburgh J held that a breach gave rise to the statutory penalty but did not render the transaction itself invalid. The judge noted, at 248, that: 'The section punishes the borrowing company on the footing that the security was and remains valid.' However, see the text accompanying n 76 above.

⁷⁹ See *Brady v Brady*, above n 70; and *Plaut v Steiner* (1988) 5 BCC 352.

⁸⁰ See *Heald v O'Connor* [1971] 2 All ER 1105; and *Re Hill and Tyler Ltd (in administration)*, *Harlow and another v Loveday and another* [2004] EWHC 1261.

⁸¹ See eg *Central Eastern Trust v Irving Oil Limited*, 110 DLR (3d) 257 (SCC).

⁸² See eg *In a Flap Envelope Co Ltd* [2004] 1 BCLC 64, discussed below at n 106. See further, *Selangor United Rubber Estates Ltd v Cradock (No 3)*, above n 37.

If the illegal element of the transaction is severable, the court will sever it and thus save the remaining parts of the agreement. For example, in *Spink (Bournemouth) Ltd v Spink*,⁸³ the defendant, a director of the claimant company, undertook to resign his post and enter into an agreement restricting his future commercial activities in consideration for a payment of £100. He also agreed to transfer 325 shares in the company to his brother, another director, in return for £250. This was duly completed and he received a cheque from the company for £350. Luxmore J held that the restrictive covenant was not invalid on grounds of public policy and assuming the payment for the shares amounted to an infringement of the prohibition, the company would be liable. In *Carney v Herbert*,⁸⁴ the issue was whether the vendors of shares in A Ltd could sue the purchaser (or the guarantor thereof) for the purchase price when a subsidiary of A Ltd had provided illegal financial assistance in relation to the purchaser's acquisition by charging land owned by it as security for the purchaser's promise to pay for the shares. If the agreement could not have been severed, the purchaser would have been able to keep the shares without any payment being made for them. Lord Brightman, delivering the opinion of the Privy Council, stated:

as a general rule, where parties enter into a lawful contract of, for example, sale and purchase, and there is an ancillary provision which is illegal but exists for the exclusive benefit of the plaintiff, the court may and probably will, if the justice of the case so requires, and there is no public policy objection, permit the plaintiff, if he so wishes, to enforce the contract without the illegal provision.⁸⁵

On the basis of this approach, the Privy Council severed the illegal charges and allowed the vendors to sue for the purchase price.⁸⁶

⁸³ [1936] Ch 544.

⁸⁴ [1985] AC 301 (PC).

⁸⁵ Ibid at 317.

⁸⁶ See also *Anglo Petroleum Ltd v TFB (Mortgages) Ltd*, above n 9, at 202–3, in which Toulson LJ, delivering the leading judgment of the Court of Appeal, expressed the view that:

In the present case it was reasonable for TFB to regard the loan as an ordinary commercial loan made in the course of its business. There is no good reason why public policy should have required TFB to investigate whether the proposed use of the loan would amount to a breach of s 151 of the 1985 Act, and the law would be out of touch with reality if it deemed TFB to have knowledge that the proposed use would be a breach . . .

Even if the use of the funds had involved a breach of s 151, the judge was right to hold that the credit agreement, the security agreement and the guarantee were not illegal. The agreements did not necessitate any breach of the law, and it was not the purpose of TFB in entering into them to procure or assist the commission of conduct which would be a breach of the law. In the circumstances, it would not be just to equate TFB's knowledge of APL's intended use of the loan with knowledge of its alleged illegality, nor would it be just to draw an inference of a shared unlawful design if a reasonable person in the position of TFB would have seen it as an ordinary commercial transaction.

1.3.5 Towards relaxing the prohibition: EU developments

As we have seen, the Second Company Law Directive currently presents an insurmountable hurdle against which further relaxation of the prohibition will fall. However, there have been limited moves at EU level for deregulating the capital regime governing public companies. At the time when the CLR Steering Group was concluding its review, the European Commission established the High Level Group of Company Law Experts (chaired by Jaap Winter, hereafter the Winter Group⁸⁷) to make recommendations on the modernization of European company law. A key recommendation put forward by the Winter Group, was that the Commission should, 'as a matter of priority', reform the Second Company Law Directive along the lines suggested by the SLIM Group (Simpler Legislation for the Internal Market),⁸⁸ together with the additional proposals put forward in its Report, termed 'SLIM Plus'.⁸⁹ With respect to the proposals of the SLIM Report in relation to reforming the prohibition, the Winter Group favoured a solution whereby financial assistance should be permitted to the extent of the company's distributable reserves. This, it noted, would provide full cover of the risk associated with the financial assistance in that the outstanding amount of a loan made by the company to acquire shares would be covered in full by the company's distributable reserves.⁹⁰ The aim appears to be to maintain the legal capital doctrine that many UK commentators view as performing no real purpose in modern times.⁹¹

The Winter Group's recommendations were broadly implemented by Directive 2006/68/EC which amended the Second Directive. It relaxes the prohibition in relation to advances, loans, and security on fair market conditions. However, complex procedural requirements were also introduced,⁹² including the need to obtain a shareholders' resolution authorizing the board to engage the company in financial assistance within the limits of the distributable reserves and such a resolution is required for each transaction or arrangement entered into.⁹³ For the typical public

⁸⁷ *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (European Commission, 4 November 2002).

⁸⁸ See *Modernising Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward* (COM(2003) 284).

⁸⁹ Above n 87, at 80.

⁹⁰ *Ibid* at 85.

⁹¹ See eg J Armour, 'Legal Capital: An Outdated Concept?', *European Business Organization Law Review* 7 (2006) 5.

⁹² For a detailed analysis of the proposed conditions and the Directive at draft stage, see E Ferran, 'Simplification of European Company Law on Financial Assistance', *European Business Organization Law Review* 6 (2005) 93.

⁹³ The Commission's commentary on the draft Directive explains, without more, that specific authorization is needed because of the 'extraordinary sensitivity' of financial assistance transactions. See Commission Working Document, Proposal COM(2004) 730 final of 29 October 2004 for a Directive of the European Parliament and of the Council amending Council Directive 77/91/EEC, as regards the formation and public limited liability companies and the maintenance and alteration of their capital—Detailed explanation (by article) at 4. See E Ferran, above n 92, at 96. The Winter

company with widely dispersed membership, the costs and delay of the requirement for *ex ante* shareholder approval renders the relaxation of the prohibition of little practical importance. As one commentator has concluded, it is hard to summon up any enthusiasm for the EU proposals.⁹⁴ Perhaps not surprisingly, the UK has not assimilated these initiatives into the 2006 Act. The Department of Trade and Industry's response was that the procedure was 'complex and onerous and is therefore unlikely to be utilised by companies'.⁹⁵

1.4 Constructing a Measured Response to Financial Assistance

While it is apparent that the courts have in recent cases been adopting a more pragmatic approach towards financial assistance through deploying the commercial realities test as seen in *MT Realisations Ltd v Digital Equipment Co Ltd* and *Dymont v Boyden*,⁹⁶ fundamental legislative reform deregulating the position of public companies seems unlikely, at least in the short term. Such pessimism seems warranted. Notwithstanding the amendments to the Second Directive, the reforms are strictly limited in scope given that the policy makers at EU level seem wedded to traditional notions of legal capital. But, were the opportunity to arise to cast the shackles of the prohibition aside, the question arises whether existing common law safeguards are adequate to protect the interests of the company, its shareholders, and creditors.⁹⁷

Group, above n 87, at 85, had favoured a more flexible approach. It recommended that a 'shareholders meeting should be allowed to authorise the board for a maximum period of time (e.g. five years) to engage the company in financial assistance within the limits of the distributable reserves'.

⁹⁴ E Ferran, above n 92, at 94.

⁹⁵ *European Company Law and Corporate Governance: Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company* (DTI, 2005) at 36. However, the Netherlands have changed their capital maintenance rules for NVs (limited liability companies which can be listed) so as to implement the changes to the Second Company Law Directive introduced by Directive 2006/68/EC. The new rules entered into force on 11 June 2008. The [Dutch] Private Company Law (Simplification and Flexibilisation) Act, which was expected to enter into force on 1 July 2010, will repeal the prohibition against financial assistance for BVs (private limited liability companies). See further, D Viëtor and M van der Zanden, 'Repeal of the Dutch Financial Assistance Prohibition for BVs: Are We Just Dressing Old Worlds New?' [2010] ICR 97.

⁹⁶ See also, *Anglo Petroleum Ltd v TFB (Mortgages) Ltd*, above n 9.

⁹⁷ Other Anglo-Commonwealth jurisdictions have seen fit to discard either in whole or in part the prohibition on financial assistance. For example, the prohibition is repealed by the Canada Business Corporations Act 2001. In Australia, financial assistance is permitted subject to certain conditions such as that the financial assistance would not materially prejudice the interests of the company or its shareholders or the company's ability to meet its debts: see the [Australian] Corporations Act 2001, ss 260A–D. The USA has not enacted financial assistance rules. US jurisdictions leave creditors and shareholders to look for protection under the general corporate laws and market-based mechanisms, for example contractual terms in the case of creditors.

Chief among the control mechanisms that prevent abuse on the part of directors are the fiduciary duties,⁹⁸ restated in Part 10 of the 2006 Act. More particularly, the proper purposes doctrine, now subsumed within the duty to act within powers,⁹⁹ and the duty to promote the success of the company,¹⁰⁰ are key. In assessing, for example, the s 171 duty to act within powers the courts have long taken a fact-intensive approach towards the determination of whether a director in exercising a power has been motivated by some improper collateral purpose. As such, it offers the potential to protect the company against inappropriate financial assistance transactions.¹⁰¹ Further, there is a synergy between the prophylactic objectives of the fiduciary duties of directors and the emphasis which the Jenkins Committee placed on the prohibition against financial assistance being aimed at preventing abuses of power.¹⁰²

⁹⁸ See *Developing the Framework*, above n 15, para 7.24; and the *Final Report*, above n 3, para 2.30.

⁹⁹ Restated in s 171 of the 2006 Act which provides that:

A director of a company must—

- (a) act in accordance with the company's constitution, and
- (b) only exercise powers for the purposes for which they are conferred.

¹⁰⁰ The duty of loyalty in s 172 appears under the guise of the duty to promote the success of the company (see *Developing the Framework* (URN 00/656, DTI, 2000), paras 2.19–2.22; and *Completing the Structure* (URN 00/1335, DTI, 2000), para 3.5). It has two elements:

- (1) a director must act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole; and
- (2) in doing so, the director should have regard (amongst other matters) to the factors listed in subsection (1).

Subs 3 goes on to provide that ‘The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.’ See J Lewry ‘The Duty of Loyalty of Company Directors: Bridging the Accountability Gap Through Efficient Disclosure’ [2009] Cambridge Law Journal 607.

¹⁰¹ The criteria for establishing a breach of duty were reviewed by Jonathan Crow (sitting as a Deputy Judge of the High Court), in *Extrasure Travel Insurance Ltd v Scattergood* [2003] 1 BCLC 598 at [92]–[93], where the directors had misused corporate assets for an improper purpose. The judge stated:

The law relating to proper purposes is clear, and was not in issue. It is unnecessary for a claimant to prove that a director was dishonest, or that he knew he was pursuing a collateral purpose. In that sense, the test is an objective one. It was suggested by the parties that the court must apply a tri-partite test, but it may be more convenient to add a fourth stage. The court must:

Identify the power whose exercise is in question.

Identify the proper purpose for which that power was delegated to the directors.

Identify the substantial purpose for which the power was in fact exercised.

Decide whether that purpose was proper. Finally, it is worth noting that the third stage involves a question of fact. It turns on the actual motives of the directors at the time . . .

See also, *Re Smith & Fawcett Ltd* [1942] Ch 304 (CA); *Punt v Symons & Co Ltd* [1903] 2 Ch 506; *Hogg v Cramphorn Ltd* [1967] Ch 254; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC).

¹⁰² Above n 11. On the policy objectives of fiduciary duties, see P Birks, *An Introduction to the Law of Restitution* (Clarendon Press, 1985) at 332–3.

The case law on financial assistance shows the willingness of the courts to go beyond the complexities of the statutory prohibition and approach the issue of liability from the perspective of breach of fiduciary duty. This is apparent from Ungood-Thomas J's examination of the conduct of the directors in *Selangor*.¹⁰³ This approach has also found favour with the modern courts. For example, in *MacPherson v European Strategic Bureau Ltd*,¹⁰⁴ the Court of Appeal held that an agreement for the distribution by an insolvent company of funds to shareholders amounted to an informal winding up which failed to make proper provision for creditors. While it was acknowledged by Chadwick LJ that an effect of the agreement was that the company provided financial assistance for the purpose of an acquisition of its shares insofar as the company's net assets were reduced to a material extent, liability was couched in terms of breach of fiduciary duty. The judge noted that:

the arrangement . . . fails to satisfy the third of the questions posed by Eve J in *Re Lee, Behrens and Co Ltd* [1932] 2 Ch 46: 'is [the transaction] . . . for the benefit and to promote the prosperity of the company?' . . . In my view, to enter into an arrangement which seeks to achieve a distribution of assets, as if on a winding up, without making proper provision for creditors is, itself, a breach of the duties which directors owe to the company . . .¹⁰⁵

Similarly, in *Re In a Flap Envelope Co Ltd*,¹⁰⁶ L Ltd, the purchaser of the target company acquired its shares in return for a price payable in instalments. When the purchaser defaulted on the repayments it was agreed that the target company would lend L Ltd the outstanding sum. The target company went into liquidation and the liquidator claimed that the financial assistance was unlawful because the 'white-wash' procedure then in force had not been complied with. Jonathan Crow (sitting as a deputy judge of the High Court), holding that the loan to the purchaser did constitute unlawful financial assistance, took the view that, 'leaving to one side the technical question' whether there was a breach of the prohibition, the defendant, the sole director of the company, was clearly in breach of his fiduciary duties.¹⁰⁷ More particularly, the defendant exercised his power as a director for his own benefit in circumstances where his interests and those of the company were in conflict. Further, he acted otherwise than in the best interests of the company given the obvious likelihood of the purchaser defaulting.

1.5 Conclusion

It seems clear that companies would be effectively safeguarded by the protection afforded by the fiduciary duties of directors in the event of the provisions prohibiting

¹⁰³ Above n 37.

¹⁰⁴ [2002] BCC 39.

¹⁰⁵ Ibid at 53.

¹⁰⁶ [2004] 1 BCLC 64.

¹⁰⁷ Ibid at 80.

the giving of financial assistance being abolished. As commented above,¹⁰⁸ the statutory prohibition is in itself of limited value in protecting the company and creditors in that it addresses only some transactions which can lead to a reduction in a company's assets and that can occur, as was acknowledged by the CLR, through any 'unwise handling of corporate assets'.¹⁰⁹ The advantage of regulating financial assistance via the fiduciary duties of directors lies in the fact that the courts can respond flexibly on a case-by-case basis to real abuses of power while leaving directors free to engage in those transactions which are genuinely in the interest of the company.¹¹⁰ From the perspective of creditors, on the other hand, there are alternative remedies which offer adequate protection. The requirements covering unlawful dividends, reductions of capital, and the provisions in the insolvency legislation relating to transactions at preference are effective responses to the policy considerations underlying the prohibition, particularly the need to protect corporate assets for their benefit.¹¹¹ Further, the Company Directors Disqualification Act 1986, s 6(1) which provides that the court shall make a disqualification order against a person where it is satisfied that his conduct as a director makes him unfit to be concerned in the management of a company,¹¹² together with the provisions on fraudulent and wrongful trading in the Insolvency Act 1986, also represent serious deterrents against abuse of power by directors by empowering the courts to re-open transactions which are prejudicial to creditors.¹¹³ It is time for the European Commission to take a bolder look at the prohibition with a view to assessing whether public companies can be just as effectively protected by alternative and well-established national mechanisms that are sufficiently flexible to permit transactions and arrangements which clearly promote the interests of the enterprise and relevant stakeholders.

¹⁰⁸ Above n 15, and associated text.

¹⁰⁹ See *Developing the Framework*, above n 15, para 7.21. The CLR added that: 'Other transactions—including payment of dividends, or even ordinary trading transactions—may also reduce a company's assets and adversely affect its ability to repay creditors.'

¹¹⁰ See eg J Rickford (ed), 'Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance' (2004) 15 *European Business Law Review* 919 at 945, noting that the prohibition is an impediment to desirable commercial transactions such as leveraged buyouts. See also, E Wymeersch, above n 9, who observes that the prohibition impedes buy-out transactions essential to the creation of profits and wealth. See R Sykes, 'Financial Assistance' (2000) 21 *Co Law* 65, who notes that the annual legal costs associated with complying with the rules is around £20m.

¹¹¹ See the *Final Report*, above n 3, para 2.30. For a comprehensive analysis of the prohibition against disguised returns of capital, see E Micheler, 'Disguised Returns of Capital—An Arm's Length Approach' [2010] *CLJ* 151.

¹¹² The CDDA 1986, as amended by the Insolvency Act 2000, has proved to be an effective weapon against breaches of 'commercial morality' (per Hoffmann J in *Re Ipcan Fashions Ltd* (1989) 5 BCC 773 at 776, citing Vinelott J in *Re Stanford Services Ltd* (1987) 3 BCC 326 at 336). Between 2001 and 2005 the average number of disqualification notices per year was 1,751.

¹¹³ See *Developing the Framework*, above n 15, para 7.23. The CLR notes that the prohibition was devised at a time prior to the safeguards now contained in the insolvency legislation.

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