
Debt finance law

Briefing

MACFARLANES

Legal Issues for English Companies in Financing Transactions

This memorandum describes briefly some of the main legal issues which are relevant when an English company is involved in a debt finance transaction. It is intended as a general introduction only and should not be relied on for specific advice on any proposed transaction.

Introductory notes

Jurisdictions within the United Kingdom

We are qualified to practise only in England & Wales and accordingly this memorandum addresses only English law. Scotland has a separate legal system which is very different from the English system. Northern Ireland also has a separate system but it is closer to the English one.

Companies and other entities

Limited companies registered in England & Wales are broadly divided into:

- public companies, which can issue securities to the public and are subject to a greater degree of regulation – their names have “PLC” or “public limited company” (or the Welsh equivalent) at the end; and
- private companies – whose names have “Limited” at the end.

The constitution of a company comprises a memorandum of association and articles of association.

The Registrar of Companies (working via Companies House) maintains a register for each registered company, including its constitution documents and all filings, and this can be searched by anyone.

Unlike some jurisdictions, England has no formal legal concept of a company being “in good standing”; but Companies House will if requested issue a “certificate of good standing” which is a brief status report about the company’s existence and whether the registrar is taking any action to remove it from the register. If a company is late in filing its annual return it will not qualify for a good standing certificate until this is rectified. No certificate can be obtained as to payment of taxes.

There are other vehicles, such as the limited liability partnership (suffix = LLP), which was introduced in 2001.

Corporate considerations

Ultra vires doctrine

Companies registered under the Companies Acts have their capacity limited by law to the objects set out in their constitution and anything reasonably ancillary to those objects. This rule remains despite several modifications and proposals to abolish it entirely. However, there is now a provision preserving the validity of transactions and thereby protecting third parties, so the rule has become largely a matter affecting the position between directors and shareholders. It rarely causes a problem in financing transactions.

Corporate authorisation

A loan, guarantee or security to be entered into by an English company needs to be approved by resolution of its board of directors. In order to convene a board meeting, notice of the meeting must be given (usually by the company secretary or by a director) to all the directors. The amount of notice given only needs to be “reasonable” and, if all directors agree, substantial prior notice can be dispensed with. The quorum, majority and voting provisions will be set out in the constitution of the company; we would check these provisions, but they do not normally cause a problem or significant timing delay in practice. It is possible, if the constitution permits, to use a written resolution of the directors instead of a board meeting. A written resolution must be signed by all the directors.

Each director owes legal duties to his individual company, regardless of whether it forms part of a group. These include a duty to act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. A breach of duty may lead to the director being liable to the company. Moreover, if a third party dealing with the company (e.g. a lender) knows or ought reasonably to have known about the breach of duty, the transaction may be set aside and/or the third party may be held liable as a constructive trustee of any benefit received. The shareholders may

by resolution approve, or later ratify, an action which would otherwise be a breach of duty. Directors do not have to be resident in Britain.

There is normally no express requirement for a loan, guarantee or security to be separately authorised by the shareholders of the company. However:

- if it is not obvious that the transaction is likely to promote the success of the company, so that there is room for doubt as to whether the directors are complying with their duties (see paragraph above), the lender(s) will often require a shareholders' resolution to approve it;
- if the transaction is outside the legal capacity of the company (see 'Ultra vires doctrine' above), it is advisable (at least from the company's point of view) to have a shareholders' resolution to authorise it or to amend the company's constitution.

This can be done by a written resolution signed by the necessary majority of the shareholders (after being sent to all of them). It can also be done by a resolution passed at an extraordinary shareholders' meeting, which is convened by giving notice to all shareholders and in the case of a private company can be held on short notice if a certain majority of the shareholders consent in writing.

Distributions and reduction of capital

As a general principle of company law, a company may not reduce its stated share capital or return capital to shareholders, except by an authorised means. As part of this there are statutory rules for distributions, which broadly require them to be paid out of distributable profits.

There have been cases in which the courts have held a transaction, despite its not looking like a dividend, to be a disguised distribution or return of capital to shareholders. So if a company makes a loan to a shareholder in circumstances where it is unlikely that the loan will be repaid, or if it guarantees a shareholder's debt in circumstances where the

guarantee is likely to be called and the company is unlikely to be promptly and fully reimbursed, there is a high risk that that could be seen as an indirect way of returning capital to the shareholder. To the extent that any provision made for such loan or guarantee (and the consequent reduction in the company's net assets) exceeds the company's accumulated distributable profits, it would be very likely to be illegal.

An unlawful distribution or return of capital cannot be approved or ratified by the shareholders and so a shareholders' resolution will not help if there is a concern on this score. However if the company has distributable reserves sufficient to cover the relevant payment, no challenge can be made.

It is advisable for a lender to require evidence that this issue has been addressed by the directors in cases where it may apply – e.g. in the directors' resolution or a separate director's certificate.

Financial assistance

English financial assistance legislation provides, first, that if a person is acquiring or is 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 that acquisition, before or at the same time as the acquisition takes place. There is also a provision that where a person has acquired shares in a company and any liability has been incurred (by that person or anyone else) for the purpose of that acquisition, it is not lawful for the company or any of its subsidiaries to give financial assistance, directly or indirectly, for the purpose of reducing or discharging the liability so incurred. One or the other of these prohibitions is relevant to guarantees and/or security given by target companies or their subsidiaries for an acquisition facility.

Prior to 1 October 2008 private companies were able to use an exemption procedure (colloquially known as the "whitewash") which allowed them to give financial assistance. The whitewash procedure was complex and involved a large amount of work,

particularly of a financial nature. However, with effect from 1 October 2008 the financial assistance legislation was amended so that it now does not apply at all to financial assistance given by a private company for the acquisition of shares either in itself or in another company which is private at the time the assistance is given. (This timing criterion means that security can be given, post-acquisition, in public-to-private buy-outs once the target PLC has been re-registered as private.)

A public company is still prohibited from giving financial assistance; and a private company may not give it for the acquisition of shares in another company which is a public company at the time the assistance is given.

Guarantees

Guarantees can be given in a wide variety of situations but they are susceptible to proving invalid if not properly drafted. English law is protective of simple guarantors (sureties). As a result guarantees of financial obligations tend to be quite long, as they contain (a) provisions contracting out of common law principles which might lead to the guarantee being discharged and (b) indemnity and primary obligor provisions in addition to "pure" guarantee wording. A guarantee must be in writing and signed by the guarantor.

With an upstream guarantee given by a subsidiary for its parent's obligations, the issue of benefit arises in the context of the duties of the directors of the subsidiary: see 'Corporate authorisation' above.

In addition the giving of an upstream guarantee by a company which is not able to pay its debts as they fall due, or thereby becomes unable to pay its debts as they fall due, can be liable to attack and invalidation as a "transaction at an undervalue" if the company enters insolvency proceedings within a period of two years thereafter (see also 'Insolvency considerations' below). The reduction of capital issue described in 'Distributions and reduction of capital' above should also be considered.

Security

Security over assets of English companies

Subject to the legal principles discussed above it is generally possible for an English company to grant security to a creditor over any or all of its assets. English law recognises a number of security interests which are easy to create and do not require onerous formalities. It is not necessary to use separate security documents for different types of asset; it is very common to use a single document (often called a “debenture” or “security agreement”) which creates a mixture of mortgages, fixed charges and floating charges (see below) over all or substantially all of a company’s assets. In syndicated or club deals the security will usually be granted to a security trustee for the benefit of all the lenders from time to time.

One of the types of English security interest is a floating charge. A floating charge can be granted over a class (or classes) of assets. It does not attach specifically to particular assets, but “floats” over the whole class, with the company having the ability to deal in those assets (i.e. dispose of them free of the charge and acquire new ones which become subject to it), until an event occurs (e.g. insolvency or ceasing business) to make the charge “crystallise”. It is therefore very useful for circulating assets such as inventory. The main differences between a fixed charge and a floating charge, briefly, are as follows:

- a A floating charge gives the company much greater liberty to dispose of the relevant assets.
- b In terms of priority upon enforcement, a floating charge ranks after:
 - any fixed charge granted over the same assets, even if the fixed charge is granted later; and
 - statutory “preferential debts”, which include contributions to pension schemes and a certain amount of employee remuneration;

and in addition a statutory fund must be set aside, out of the proceeds

realised from the charged assets, for the benefit of unsecured creditors generally (this currently cannot exceed £600,000).

- c A floating charge can be invalid if the company subsequently enters insolvency proceedings within a certain period (one year, unless the lender is “connected” with the company, in which case it is two years); if this applies the floating charge is invalid except to the extent of, broadly, new money or other consideration paid or provided to the company itself at the same time as, or after, the creation of the charge.

A difficulty is that even where the parties have expressly described a charge as fixed, the courts will hold it to be floating if the legal rights actually created are more consistent with a floating charge. This has notably been the case in relation to receivables. As the law now stands, in order to be confident of having a fixed charge over receivables, a lender must actually exercise control over those receivables and over their proceeds of payment (i.e. cash received by the company). To obtain this control in practice, a lender will usually need to require the company to pay the cash receipts from its receivables into a specified bank account and then control whether or not the company can withdraw the cash from that account. This degree of control will not be practicable for most companies, especially trading companies, and so in practice the security taken by lenders over receivables of most companies will be, in law, a floating charge.

Security over shares in English companies

It should be possible, as a matter of English law, for the shareholders of an English company (even if those shareholders are not UK entities) to grant security over the shares they hold in that English company. Security over shares is usually created by way of a legal mortgage or an equitable charge. In order to obtain a legal mortgage, the shares actually have to be transferred to the lender or an agent for the lender (or a nominee for it) and registered in the name

of the lender or agent (or its nominee). In the case of an equitable charge, the shares are not transferred to and registered in the name of the lender/agent at the outset, but it is usual practice for the lender to require the certificates for the shares, plus transfer forms executed in blank, to be deposited with it.

Registration of security

Security is generally effective as soon as it is created between the parties. However, some registrations are necessary or desirable in order to prevent retrospective invalidity or to confer priority.

With nearly all types of security created by a company, the security document, together with the prescribed notification form setting out particulars of it, must be registered at the Companies Registry within 21 days after creation, failing which the security will be void against any liquidator or administrator and the creditors of the relevant company. This requirement applies to:

- companies incorporated in England & Wales (or in Scotland or Northern Ireland); and
- companies incorporated elsewhere which have a place of business anywhere in the UK, if they create security over any property or asset situated in the UK.

With a mortgage or charge over real estate, registration of the security document at H.M. Land Registry or the applicable land charges registry will also usually be made, in order for the lender to obtain priority for the security. With a mortgage or charge over intellectual property, registration of the security document in the applicable register of intellectual property rights may be necessary to ensure the validity and/or priority of the security. There are also registries where security over ships and aircraft can be filed.

There is a registration fee (currently £13) for each security document registered at the Companies Registry. Registration fees are also payable for the registration

of security over real estate at the Land Registry and for the registration of security over intellectual property, but these fees are not onerous. It is usual in the UK for the company to bear the costs of registrations.

Security registrations, once made, remain until a notice of release is filed and do not lapse or need renewal.

Searches for existing security can be made at the Companies Registry and in the specialist registers; however they may not reveal the existence of recently-created security which has not yet been filed (or which has been filed but the details of which have not yet been placed on the public register).

Intercreditor arrangements

English law will recognise subordination effected by contract or by trust, so long as it does not conflict with the statutory rule that in a liquidation creditors must be paid *pari passu*. Because of this qualification the effectiveness of subordination in a liquidation cannot be absolutely guaranteed. Nevertheless intercreditor or subordination agreements are commonly used. Subordination can also be achieved structurally.

Insolvency considerations

In general terms English law is creditor-friendly. However over the last few years the Government's policy of promoting a "rescue culture" for financially troubled businesses has led to a degree of scaling back of the rights of secured creditors; in particular, secured creditors now have far less ability to enforce security by appointing an administrative receiver (who has a wide range of powers and whose appointment would prevent the company instituting insolvency proceedings of its own which cause a moratorium on security enforcement).

There are also provisions allowing an insolvency officer to challenge certain past transactions and seek a court order reversing or remedying their effects. This is possible, for example, if there has been a "transaction at an undervalue" (where the company did not receive full consideration) or a "preference" (where the company deliberately put a creditor into a better position). In most cases this can only happen if the company was in an insolvent condition at the time of the transaction, or entered an insolvent condition as a result of it. (Note: "insolvent condition" here refers to the company's financial condition and does not require actual insolvency proceedings to have commenced at the time of the transaction.)

Contact details

If you would like any further information or specific advice please contact your usual Macfarlanes contact, or

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This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

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