GUARANTEES AND DISTRIBUTIONS

1 This note is concerned with the following question: If an English company, which is a member of a group of companies, gives a guarantee to a creditor of its parent company or of a fellow subsidiary, can that guarantee constitute a distribution of assets to its members?[1]

2 The conclusion is that a guarantee given in relation to a normal financing transaction cannot constitute a distribution.

3 When we refer to a "normal financing transaction", we mean a transaction in which, at the time the guarantee is given, the board of directors of the guarantor properly considers the financial position of the member of the group to whom the credit is provided and concludes, in good faith and on reasonable grounds, that it is likely to be able to repay or refinance the credit when due and therefore that a claim is unlikely to be made on the guarantee.

Background

4 This note has been prompted by a paper produced by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland containing *Guidance on Realised and Distributed Profits under the Companies Act 2006 (Tech 02/17BL)*. Paragraph 9.69 of that paper suggests that guaranteeing the debt of a parent or fellow subsidiary without receiving an appropriate fee might, as a matter of law, involve a distribution. We are mindful of the discussion contained in that paper but, in our opinion, a guarantee given in relation to a normal financing transaction does not constitute a distribution, whether or not a fee is payable.

5 This is a very important issue in practice. Businesses of any size are rarely constituted in one corporate entity. It is commonplace for businesses to consist of a parent company and a group of subsidiaries. It is also commonplace for creditors of a parent company to require guarantees (and often security) from its subsidiaries. That gives the lenders access to the assets of the subsidiaries themselves, rather than just the assets of the parent company.

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[1] This note is also relevant to transactions having a similar effect, such as a third party charge.

Directors' duties and insolvency law

6 The directors of a subsidiary must act in accordance with their fiduciary duties which are owed to the subsidiary. One such duty is that the directors of a subsidiary must exercise their powers in the best interests of the subsidiary itself, rather than in the interests of the group as a whole.[2]

7 If the directors approve the giving of a guarantee in breach of fiduciary duty, and the beneficiary of the guarantee has actual or constructive notice of the facts giving rise to the breach of duty, the subsidiary can avoid the guarantee and recover any benefits conferred under it.[3]

8 The main consideration for the board of a subsidiary which is considering giving a guarantee to a creditor of its parent company or of a fellow subsidiary is whether the guarantee is likely to be called. This depends on the ability of the company concerned to repay or refinance the credit. The board of directors of the subsidiary needs to consider the actual and prospective financial condition of the company concerned and the likelihood that it will be able to repay or refinance the credit when required.

9 This is a judgement which the board of the subsidiary needs to make at the time the guarantee is given, based on the information which is available to it – or which ought to be available to it – at that time. It is not affected by subsequent developments.

10 The question is whether the board of the subsidiary can conclude, in good faith and on reasonable grounds, that the company receiving the credit is likely to be able to repay or refinance it when due. If the board cannot do so, it should not approve the guarantee without making appropriate arrangements to protect the subsidiary. If the board can do so, it then needs to consider whether it is appropriate to give the guarantee in the circumstances.

11 There is no legal requirement to charge a fee for the issue of a guarantee. If the board of the subsidiary considers it unlikely that the guarantee will be called,

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[2] *Charterbridge Corporation v Lloyds Bank* [1970] Ch 62 at 74.
[3] *Rolled Steel Products v British Steel Corporation* [1986] Ch 246.

it may take the view – in the context of the entire transaction and also in the context of the overall relationship between the parties – that it is appropriate to enter into the guarantee without charging a fee. The board of the subsidiary may consider, for example that in facilitating the parent company's access to financing by giving the guarantee, the subsidiary receives other benefit from giving the guarantee. This might arise in a number of different circumstances. By way of illustration, the subsidiary may be dependent on being part of a financially stable group of companies where the subsidiary is able to access its parent's management and expertise or to benefit from the provision of shared services within the group or other synergies arising from being part of the group. The subsidiary might also benefit from being able to access or having the potential to access the parent's financing either directly or indirectly on more favourable terms than it could obtain for itself.

12 Insolvency law also has a role to play. If the subsidiary goes into administration or liquidation, the guarantee may constitute a transaction at an undervalue under section 238 of the Insolvency Act 1986, and it may be set aside if the directors did not properly take account of the interests of the subsidiary.

13 These rules ensure that the directors of the subsidiary properly consider the interests of the subsidiary when deciding whether or not to enter into the guarantee. This note considers whether, in addition to these rules, there is a further requirement that the guarantee satisfies the rules concerning distributions.

Distributions

14 Company law regulates the circumstances in which companies can make distributions to their members through both statute and common law maintenance of capital principles.

15 The statutory rules on distributions are contained in Part 23 of the Companies Act 2006. A distribution is defined by Section 829(1) of the Companies Act 2006 as "every description of distribution of a company's assets to its members, whether in cash or otherwise".

16 There is no more specific definition of "distribution" in the Companies Act. We consider that a distribution must involve a disposition of the assets of the company to or for the benefit of its shareholders. Support for this is found in Section 845, which (under the heading "Distributions in kind: determination of amount") applies to "a sale, transfer or other disposition by a company of a non-cash asset". In our opinion, a binding commitment to dispose of an asset amounts to a disposition of that asset. If a subsidiary uses its own assets to discharge a liability of its shareholder (so it is certain when the subsidiary agrees to do this that its assets will be depleted) without appropriate consideration, this will also be a distribution. If the liability is unliquidated, this will be treated as a transfer of a non-cash asset.[4]

17 Case law establishes that a transaction may constitute a distribution even if the subsidiary's assets are not transferred to the parent company if they are transferred to another person for the benefit of the parent[5].

18 The cases show that excessive payments of interest or of directors' fees to a shareholder may amount to a distribution.[6] There is also authority for the proposition that a sale by a company of an asset at an undervalue to an associated company for the benefit of its shareholder can constitute a distribution[7]. The fact that the parties do not describe a transaction as a distribution is not conclusive.

19 The leading case is *Progress Property Co v Moore*[8]. Here, the Supreme Court confirmed that the court must look at the substance, rather than the outward appearance, of the transaction. The mere fact that a company has entered into a transaction at an undervalue with its parent company is not, of itself, sufficient to make the transaction a disguised distribution. But it will be a distribution if that is in substance what was intended. If a transaction involves a disposition of assets at an undervalue to or for the benefit of the shareholder, a "margin of appreciation" is allowed in assessing the adequacy of the consideration

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[4] Section 1163(2)(b), Companies Act 2006.
[5] *Aveling Barford v Perion* [1989] BCLC 626.
[6] *Ridge Securities v IRC* [1964] 1 WLR 479; *Re Halt Garage* [1982] 3 All ER 1016.
[7] *Aveling Barford v Perion* [1989] BCLC 626.
[8] [2011] 1 WLR 1.

received for the disposition. If the consideration received is within this margin of appreciation, the transaction will not be regarded as a disguised distribution.[9]

Can a guarantee be a distribution?

20 The fact that a subsidiary does not charge a fee for providing a guarantee does not result in a disposition of the subsidiary's assets and therefore does not, of itself, give rise to a distribution.

21 A subsidiary entering into a guarantee in favour of a creditor of its parent or of a fellow subsidiary assumes a contingent liability that may result in the disposition of its assets for the benefit of its parent. That may amount to a distribution but only if (i) the intention is that the guarantee will be called (or, viewed objectively, that is likely) and (ii) the subsidiary does not receive appropriate value for assuming that contingent liability.

22 Whether entering into a guarantee constitutes a distribution must be tested at the time it is entered into. If it is not a distribution when entered into, it will not be a distribution should it later be called.

23 If at the time a guarantee is entered into the directors of the subsidiary believe (or would believe if they properly addressed their minds to the question) it is inevitable (or likely) that the guarantee will be called, there is a risk that a court would find that entering into the guarantee amounted to a distribution. In these circumstances, if the subsidiary receives full value for entering into the guarantee there will be no distribution. If the subsidiary identifies some benefit for giving the guarantee[10] even if not full arm's length value it will be less likely that a court would find that the intention was to make a distribution (or that a distribution was being made) if the value of the benefit is within the margin of appreciation.

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[9] Clydebank Football Club v Steedman [2000] ScotCS 250, 2002 SLT 109. In that case "margin of appreciation" was explained as follows: "If the transaction is genuinely conceived of and effected as an exchange for value and the difference ultimately found does not reflect a payment 'manifestly beyond any possible justifiable reward for that in respect of which allegedly it is paid', does not give rise to an exchange 'at a gross undervalue' and is not otherwise unreasonably large, there will not to any extent be a 'dressed up return of capital'. In assessing the adequacy of the consideration, a margin of appreciation may be properly allowed".

[10] The assessment of value and the benefit the subsidiary receives will depend upon the relevant circumstances. Some considerations are described in paragraph 11 above.

24 In our opinion, therefore, where a guarantee is given by a group company as part of a normal financing transaction, the guarantee will not amount to a distribution.

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DISCLAIMER:

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