INTRA-GROUP LOANS AND DISTRIBUTIONS

1 This note is concerned with the following question: If an English company, which is a member of a group of companies, makes an on-demand loan to its parent company or to a fellow subsidiary, can that loan constitute a distribution of assets to its members?

2 The conclusion is that a normal on-demand intra-group loan, whether interest-bearing or not, is not a distribution.

3 When we refer to a "normal on demand intra-group loan", we mean a loan made by a subsidiary to its parent company or to a fellow subsidiary that is repayable immediately on demand by the lender, where, at the time the loan is made, the board of directors of the subsidiary properly considers the borrower's financial position and concludes, in good faith and on reasonable grounds, that it is likely to be able to repay the loan when repayment is demanded.

Background

4 This note has been prompted by a paper produced by the Institute of Chartered Accounts 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 02/17 BL)*. Paragraphs 9.45 to 9.68 of that paper are concerned with intra-group loans on off-market terms. In particular, paragraphs 9.60 to 9.64 deal with interest-free loans from subsidiaries to parents, and paragraphs 9.67 and 9.68 cover loans repayable on demand.

5 These provisions of the paper consider not just the accounting treatment of intra-group loans, but also whether they constitute distributions as a matter of law. It is only the latter issue with which we are concerned in this note.

Directors' duties

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.[1]

7 The main consideration for the board of a subsidiary which is considering making a loan to its parent company or to a fellow subsidiary is the ability of the borrower to repay or refinance the loan. The board of directors of the subsidiary needs to consider the actual and prospective financial condition of the borrower and the likelihood that it will be able to repay or refinance the loan when repayment is demanded.

8 This is a judgement which the board of the subsidiary needs to make at the time the loan is made, based on the information which is available to it – or which ought to be available to it – at that time.[2]

9 The question is whether the board of the subsidiary can conclude, in good faith and on reasonable grounds, that the borrower is likely to be able to repay or refinance the loan when repayment is demanded. If the board cannot do so, it should not approve the loan without making appropriate arrangements to protect the subsidiary. If the board can do so, it then needs to consider whether it is appropriate to grant the loan in the circumstances.

10 The circumstances will include the terms on which the loan is to be made. The key issue will normally be whether interest will be payable (and, if so, at what rate).

11 There is no legal requirement to charge interest on a loan. If the board of the subsidiary considers it likely that the borrower will be able to repay or refinance the loan when repayment is demanded, 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 make the loan on an interest-free basis or

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[1] *Charterbridge Corporation v Lloyds Bank* [1970] Ch 62 at 74.
[2] If circumstances change after the loan has been made, the board of the subsidiary should consider whether the borrower will still be able to repay or refinance the loan and assess whether it is in its best interests to demand repayment.

at an interest rate which is lower than a market rate. The board of the subsidiary may consider, for example, that the subsidiary receives other benefit from making a loan to the parent company. 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 Fiduciary duties require that the directors of the subsidiary properly consider the interests of the subsidiary when deciding whether or not to make a loan and on what terms. This note considers whether, in addition to these rules, there is a further requirement that the loan satisfies the rules concerning distributions.

Distributions

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

14 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".

15 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".

16 The cases show that excessive payments of interest or of directors' fees to a shareholder may amount to a distribution.[3] 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.[4] The fact that the parties do not describe it as a distribution is not conclusive.

17 The leading case is *Progress Property Co v Moore*[5]. 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 received for the disposition. If the consideration received is within this margin of appreciation, the transaction will not be regarded as a disguised distribution.[6]

Can an intra-group loan be a distribution?

18 The fact that a subsidiary does not charge interest (or charges interest at a rate less than the market rate) on a loan does not result in a disposition of the subsidiary's assets and interest foregone is not a distribution.

19 Although a loan involves a transfer of cash from the lender to the borrower we do not consider that amounts to a distribution if repayment of the loan may be demanded at any time because the lender retains the ability to demand repayment whenever it needs the cash for its business. The loan may amount to a distribution but only if (i) viewed objectively, it is likely that the borrower will not be able to repay the loan, when demanded, and (ii) the subsidiary does not receive appropriate value for assuming that risk. If there is no intention that the

[3] *Ridge Securities v IRC* [1964] 1 WLR 479; *Re Halt Garage* [1982] 3 All ER 1016.
[4] *Aveling Barford v Perion* [1989] BCLC 626.
[5] [2011] 1 WLR 1.
[6] 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".

borrower should ever be required to repay the loan it is likely that the transaction would be a distribution.

20 Whether making a loan constitutes a distribution must be tested at the time the loan is entered into. If it is not a distribution when entered into, a subsequent failure to repay will not render the original loan a distribution.

21 In our opinion, therefore, a normal on-demand intra-group loan will not amount to a distribution.

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