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British Venture Capital Association

Financial assistance and the payment of legal (and other advisory) fees: Note of consultation with Robin Potts Q.C. at Erskine Chambers on 24 July 2003

In attendance: Robin Potts Q.C.

Jeryl Andrew, Chair of the Legal and Technical Committee of the British Venture Capital Association ("BVCA")

Simon Witney and Matthew FitzGerald, SJ Berwin

James Bermingham, Norton Rose

1 Fee payment arrangements

1.1 Counsel referred to his instructions and confirmed that he remains of the view that an agreement by a company (the "investee company") to pay the legal (and other advisory) fees of a subscriber for shares in that company (the "investor") (referred to below as "fee payment arrangements") will not, in general, be prohibited "financial assistance" within the meaning of Section 151 *et seq* of the Companies Act 1985 (the "Act").

1.2 Counsel referred to the leading judgment of Lady Justice Arden in the recent case of *Robert Chaston v SWP Group plc 2002* ("*Chaston*") and noted that this decision was not directly relevant to the issue of determining whether fee payment arrangements between an investor and an investee company constituted "financial assistance". This is because the facts of *Chaston* related to a transfer of shares, rather than a subscription for shares.

1.3 However, the judgment in *Chaston* did signal a change of approach when examining the issue of whether "financial assistance" was being provided. The facts of *Chaston* involved the subsidiary of the target agreeing to pay due diligence fees for the benefit of the purchaser. Lady Justice Arden commented (at paragraph 38) in relation to such fees that:

"As a matter of commercial reality, the fees in question smoothed the path to the acquisition of shares. There was no provision in the agreement for any benefit to be given to the [target] group."

1.4 In *Chaston*, the agreement to pay the advisory fees was "financial assistance" within Section 152(1)(a)(iv) because there was a material reduction in the net assets of the target company. Similarly, as the transaction involved a share transfer (rather than a subscription for shares), there was no provision of any benefit to the target company for the payment of advisory fees by its subsidiary. On the facts of *Chaston* (or any similar facts), Counsel accepted that it was hard to argue that "financial assistance" was not being provided.

1.5 However, in light of the approach taken in *Chaston*, Counsel also said that it was now more difficult to argue, as he had in his opinion to the BVCA in 1991, that fee payment arrangements were entirely outside the scope of the phrase "financial assistance". The question asked by the court in *Chaston* could lead to the conclusion that there was "assistance" provided by the fee payment arrangement although Counsel felt that the position was certainly not settled beyond doubt. It remained arguable that fee payment arrangements are outside the scope of the words "financial assistance" as used in Sections 151 et seq.

1.6 If, however, fee payment arrangements are within the scope of the words "financial assistance", Counsel considered that it would be necessary to consider Section 152 of the Act.

2 Application of Section 152(1)(a)

2.1 To constitute unlawful "financial assistance", Counsel stated that the relevant fee payment arrangements must fall within one of the heads of financial assistance contained in Section 152(1)(a) of the Act. As a result, one must find a head of financial assistance within Section 152(1)(a) that is applicable in the circumstances of the case. In this regard, Counsel was of the view that fee payment arrangements between an investor and an investee could only fall within Section 152(1)(a)(ii) or Section 152(1)(a)(iv).

Section 152(a)(ii)

2.2 Section 152(1)(a)(ii) includes as "financial assistance" any "financial assistance given by way of guarantee, security or indemnity ... or by way of release or waiver". Fee payment arrangements do not involve any "guarantee", "security" or "release or waiver".

2.3 Counsel stated that, in his opinion, fee payment arrangements did not constitute an "indemnity", as that requires an undertaking by one person to make good a **loss** sustained by another. Counsel referred to the decision of the Court of Appeal in *Barclays Bank plc v British & Commonwealth Holdings plc* [1996] 1 WLR 1 which, in Counsel's view, clarified that matter beyond doubt.

2.4 Aldous LJ in *British & Commonwealth* cited with approval the judgment of Holroyd Pearce LJ in the case of *Yeoman Credit Ltd v Latter* ([1961] 2 All ER 294 at 328) in which it was held that "an indemnity is a contract by one party to keep the other harmless against loss" and that an indemnity is a particular thing known to the law and having special characteristics.

2.5 In *British & Commonwealth* Aldous LJ also stated (at 14):

"The words 'financial assistance' are not words which have any recognised legal significance whereas the word 'indemnity' does. It is used in the section as one of a number of words having a recognised legal meaning."

2.6 Counsel also confirmed that, in determining whether the payment of an investor's legal fees constituted financial assistance in the context of a subscription for shares, there was no distinction between in-house legal fees and external legal fees such that the payment or reimbursement of either of these types of legal fees by the investee company to the investor would not constitute prohibited financial assistance.

2.7 Counsel therefore concluded that fee payment arrangements were not financial assistance within the meaning of Section 152(a)(ii). Counsel did, however, make it clear that this line of reasoning relied upon the fee payment arrangement being put in place before the fees were incurred.

Section 152(1)(a)(iv)

2.8 To constitute financial assistance within Section 152(1)(a)(iv), the financial assistance must result in the net assets of the company being reduced to a material extent or be given by a company with no net assets. In examining whether there was a material reduction in the net assets of the investee company, Counsel advised that it was necessary to look at the position of the investee company before the financial assistance was provided and then the position of the investee company afterwards.

2.9 Adopting this approach, Counsel advised that (provided that the professional fees of the investor did not exceed the subscription monies contributed to the investee company), there would be an increase in the net assets of the investee company as a result of the transaction. As a result, there could be no "financial assistance" within Section 152(1)(a)(iv) for a company

which had positive net assets at all material times. In this context, Counsel referred to the decision in *Charterhouse Investment Trust Ltd v Tempest Diesels Ltd* [1986] BCLC1, in which Hoffmann J stated (in the context of the previous provision dealing with financial assistance, being Section 54 of the Companies Act 1948):

"It is necessary to look at [the] transaction as a whole and decide whether it constituted the giving of "financial assistance". This must involve a determination of where the net balance of financial advantage lay."

2.10 Counsel cited this passage because, in examining the issue of financial assistance, one must establish where the "net balance of financial advantage lies". In the case of a subscription of shares, Counsel advised that it was clear that the investee company received financial advantage as a result of the subscription of shares by the investor.

2.11 For companies with negative net assets before the share subscription, but positive net assets after it, the position was the same, since the fee payment arrangements were conditional upon the subscription taking place (and therefore could only give rise to an obligation on the investee company to pay at a time when the investee company had positive net assets).

2.12 However, the position was more difficult where the company providing the assistance had negative net assets after the subscription for shares. In that case, it was arguable that the arrangement would come within Section 152(1)(a)(iv). In this respect, Counsel referred to the judgment of Laddie J in *MT Realisations Ltd v Digital Equipment Co Ltd [2002] EWHC 1628 (Ch)* ("MT Realisations") at first instance.

2.13 In *MT Realisations*, Laddie J considered the submission that Section 152(1)(a)(iv) be nominally split into two parts; 'financial assistance given by a company the net assets of which are thereby reduced to a material extent' and 'financial assistance given by a company which has no assets' and then stated that:

"If these submissions are correct, then the impact of the transaction on the asset position of the target company is wholly irrelevant to the question of whether it is financial assistance where the company has no net assets. This means that where such target companies are concerned, directors will commit criminal offences not only when they procure the company to engage in a commercially neutral transaction, but also when they enter into transactions which improve its asset position. In the absence of compelling indications in the legislation and bearing in mind that this is a penal provision, I do not accept that this can be what s152(1)(a)(iv) was intended to achieve."

2.14 Laddie J then accepted the following construction of Section 152(1)(a)(iv), in the context of considering the net assets position of the company providing assistance:

"... where a target company has net assets, mathematical precision is not required, as long as the transaction does not materially reduce its assets, no breach has been committed. If the target company has no assets, no leeway is given. It is not open to the directors to procure it to enter into a transaction for the purpose of assisting in the purchase of its own shares if that transaction would reduce its assets (or increase its liabilities) even by a small amount. In my judgment ... this construction [of Section 152(1)(a)(iv)] is to be preferred..."

" In a case where there is no net flow of assets from the target company to the purchaser, nor the adoption of financial liability by the former for the benefit of the latter, the former cannot be said to be 'giving' anything financial to the latter."

2.15 However, Counsel said that the Court of Appeal in *MT Realisations*, whilst agreeing with the decision in *MT Realisations* on other grounds, was silent on that particular line of reasoning.

It was generally thought that, in that respect, Laddie J had been wrong and it would be dangerous to rely upon it.

3 Issue of shares at a discount

3.1 In confirming Counsel's previous view that fee payment arrangements between an investor and an investee company do not constitute "financial assistance", Counsel raised a separate issue which needs attention when fee payment arrangements are in contemplation.

3.2 Counsel referred to Section 100 of the Act, which provides that a company's shares shall not be allotted at a discount to nominal value. Counsel said that if the investor subscribed for shares at their nominal value (ie with no share premium) and the investee company paid the investor's legal fees, the shares would have been issued at a discount and therefore in contravention of Section 100.

3.3 However, Counsel indicated that this problem would not arise where shares were being issued at a premium sufficient to cover the fee payment. In these circumstances, an amount equal to the fee payment would be debited against the share premium account of the investee company. This is permitted by Section 130 of the Act.

3.4 In raising the potential application of Section 100, Counsel clarified that this Section would not be applicable in relation to the issue of convertible loan notes at a discount. This is because Section 100 only prohibited the allotment of "shares" at a discount.

4 Valuation fees on transfer

4.1 Counsel then considered whether provisions in articles of association which, on a transfer of shares (whether voluntary or compulsory), require the company to bear the cost of a valuation of the shares by the company's auditors (which may be necessary when, for example, there is a compulsory transfer of shares at "fair market value" to another shareholder, or back to the company itself) could be in breach of Section 151 *et seq* of the Act.

4.2 Counsel indicated that the inclusion of such a provision in the articles of association would not constitute financial assistance if (as Counsel assumed was normally the case) at the time the articles of association were adopted no particular acquirer of the shares or proposed acquirer of the shares had been identified.

Approved

26/9/03