FINANCIAL ASSISTANCE - CAPPED v UNCAPPED GUARANTEES

Introduction

The Companies Act 1993 established a permissive financial assistance regime in contrast to the prohibitive regime that prevailed under the 1955 Act. However, as a result of what appears to be an irreconcilable conflict between several provisions of the 1993 Act, uncertainty exists as to the application of the new provisions, particularly in the situation of a take-over target and its subsidiaries guaranteeing the liability of the purchaser to the acquisition lenders. In such circumstances, the boards of the relevant companies and the lenders must decide whether uncapped guarantees may be given and taken, or, if not, the nature, extent and duration of the cap that applies.

Legislative framework

The 1993 Act sets out four possible procedures facilitating the giving of financial assistance. Three of the procedures are contained in s76, while the remaining procedure is set out in s107. It is a prerequisite to each of these procedures that the solvency test is met immediately after the financial assistance is given (s77(1), in the case of the s76 procedure, and s108(1), in the case of the s107 procedure). The solvency test is set out in s4.

Pursuant to s4(1), a company satisfies the solvency test if:

(a) it is able to pay its debts as they become due in the normal course of business; and

(b) the value of its assets is greater than the value of its liabilities, including contingent liabilities.

In determining the value of a contingent liability for the purposes of s4, account may be taken of:

(a) the likelihood of the contingency occurring; and

(b) any claim the company is entitled to make and can reasonably expect to be met to reduce or extinguish the contingent liability,

(subsection (4)).

Pursuant to ss(4) a guarantor, in valuing its liability under a guarantee for the purposes of determining compliance with the solvency test, is entitled to take account of the rights of contribution and subrogation that arise as a result of the giving of that guarantee. Accordingly, in the situation of subsidiaries that are party to a group cross-guarantee, where solvency issues could arise if the face value of the contingent liability were to be included (in that the guarantee liability often exceeds the net assets of individual members of the guaranteeing group), each such subsidiary should (applying ss(4)) be entitled to value that contingent liability at zero for the purposes of the solvency test, provided that each member of the guaranteeing group is solvent at the time and the relevant subsidiary has no expectation that its obligation under the guarantee is likely to be called in the foreseeable future.

In contrast s77(6) and s108(5), which modify the solvency test in relation to the s76 and s107 procedures respectively, require all liabilities, including contingent liabilities, incurred in connection with the giving of financial assistance to be valued at their **face value** for the purposes of the solvency test.

S77(6) reads:

> In applying the solvency test for the purposes of this section, -
>
> "Assets" excludes amounts of financial assistance given by the company at any time under section 76 of this Act in the form of loans; and
>
> "Liabilities" includes the face value of all outstanding liabilities, whether contingent or otherwise, incurred by the company at any time in connection with the giving of financial assistance under section 76 of this Act.

S108(5) is worded similarly in all material respects.

The intention underlying Ss77(6)/108(5) is clear. In determining compliance with the solvency test for the purposes of the financial assistance provisions, s4(4)(b) should be ignored (ss4(a) will remain applicable) and it is the face value of the contingent liability (incurred in connection with the financial assistance) that must be taken into account.

On this basis, unless the view is taken that it is possible in formulating the solvency test in such circumstances to include as assets the face value of the contingent assets that arise because of the granting of the guarantee (ie the rights of contribution and subrogation), rather than merely taking account of those contingent assets as discounting factors in terms of valuing the relevant contingent liability (which would be unusual in terms of accepted accounting practice and for which there is no statutory authorisation), the only conclusion that can be reached is that the guarantee must be capped.

However, the position is then confused by the provisions of s77(7) and s108(5A) respectively, each of which was inserted by subsequent amendment. They read:

> Nothing in subsection (6) [(5)] of this section limits or affects the application of section 4(4).

On their face, therefore, a clear and potentially irreconcilable conflict exists between the provisions of these sections and their immediate predecessors.

In light of this conflict, two possible approaches have emerged in practice to determining the effect of s77(7) and s105(5A) (I will only refer to s77(7) from now on, but the same analysis applies for s108(5A)).

The first is that ss(7) abrogates the extended solvency test contained in s77(6), so that, in terms of the cross guarantee situation referred to, the directors are able to utilise s4(4) in valuing the guarantee and take into account the rights of contribution and subrogation that arise. On this basis, subject to the directors forming a view on the likelihood of the guarantee being called and the solvency of the guaranteeing group at the time (and therefore the value of the contingent assets that arise as discounting factors), it is possible for uncapped guarantees to be taken.

The arguments that have been put forward in support of this approach are:

(a) S77(7) must have some purpose. For it to have any effect it must override s77(6) and allow guarantees and other contingent liabilities to be valued at less than their face value after taking into account the s4(4)(b) considerations.

(b) S77(7) was added by specific legislative amendment. Parliament must, therefore, have intended something by it.

(c) The plain meaning of s77(7) is that the considerations in s4(4) are to be taken into account - s77(7) states that "nothing" in s77(6) affects the application of s4(4). To construe it otherwise does not give any meaning to the unambiguous words of s77(7).

(d) Without s77(7) it would be impossible in most situations for a subsidiary to give any kind of guarantee in a group guarantee situation if one were to treat the guarantee at its face value. This would defeat the flexibility contained in the 1993 Act.

The alternative approach lies at the other extreme. Either Ss77(6) and (7) should be treated as irreconcilable, with s77(6) prevailing or, applying ordinary principles of statutory interpretation, both subsections must be interpreted so as to give them meaning, with s77(7) being construed such that it applies to all other contingent liabilities, but not the contingent liability constituting the financial assistance. On this basis the guarantee must be capped.

The arguments that have been put forward in support of this approach are:

(a) To take the view that s77(7) overrides s77(6) means that contingent liabilities given in connection with financial assistance can be discounted in accordance with s4(4) and the expanded definition of "liabilities" contained in s77(6) is of no meaning, which can hardly have been intended by the legislature.

(b) Ordinary principles require this result, namely:

 (i) Where two provisions are in conflict, it is permissible to read down one of the provisions, taking into account the scheme and purpose of the Act (*Grey v Pearson (1857) 6 HL Cas 61 and Waitemata City Council v Auckland Regional Authority [1982] 2 NZLR 136)*. Of the two provisions s77(7) is the more ambiguous, and taking into account the scheme of the Act, namely to permit financial assistance to be given but on the basis that greater responsibility is placed on the directors and a higher threshold solvency test is met, it should be read down such that it is construed as applying in respect of all other liabilities, but not the relevant contingent liability (ie section 4(4) continues to apply for all other purposes where the solvency test is required to be met).

 (ii) It is only in exceptional circumstances that application of the rule of interpretation relating to general as against specific provisions results in one provision being regarded as surplus or redundant (*Welam v Samson (1886) NZLR 5 SC 208*). This will only be applied if there is no way of reconciling the provisions applying more general principles (ie as set out above). In any event:

  (1) S77(6) could not be said to be a general provision, in terms of seeking to apply the relevant principle of interpretation;

(2) Even though it refers to that section, it is not possible to say that s77(7) is more specific than s77(6), in that it is possible (applying ordinary principles) to construe s77(7) (and the reference to ss77(6)) in a fashion that gives s77(7) a meaning that is not in conflict with (or overriding) s77(6) and does not render part of it redundant.

(c) The analysis that to adopt this approach is to defeat the flexibility contained in the Act is not supportable. This interpretation does not mean that a guarantee can not be taken, but rather requires that that guarantee must be capped at the net assets of the relevant guarantor (and then only, potentially, for a defined period of time). The scheme of the Act is to permit financial assistance to be given, provided existing creditors are protected by the application of a stricter solvency test. Capping a guarantee at the net assets of the guarantor achieves this, while still significantly improving the position of the acquisition lenders, because they are able to obtain direct recourse to those net assets, whereas prior to the 1993 Act they could not.

Consequences of non-compliance

Given the uncertainty that arises, the consequences of non-compliance need to be considered.

Under the 1955 Act, the giving of financial assistance in contravention of that Act was unlawful, with the relevant transaction being unenforceable, unless validated under the Illegal Contracts Act 1970. In contradistinction to the position under the 1955 Act, s81 of the 1993 Act sets out the consequences of failing to comply with Ss76, 78, 79 or 80. It provides:

> (1) Failure to comply with section 76 or section 78 or section 79 or section 80 of this Act does not affect the validity of the transaction.
>
> (2) This section does not affect a liability of a director or any other person for breach of a duty, or as a constructive trustee, or otherwise.

Interestingly the section refers to Ss76, 78, 79 and 80 only and not Ss77, 107 or 108. So the question that arises is whether there is a difference between not correctly following the relevant procedure (as set out in s76, for example) as against not complying with the revised solvency test set out in s77. Secondly, is there a reason why s107 does not contain an equivalent provision to s81? Were the consequences of failure to comply with Ss107 and 108 intended to be more severe than not complying with the s76 procedure?

One approach is to argue that s77 merely forms part of the s76 procedure and therefore is encapsulated by the reference to s76 in s81 (although it is interesting to note in this regard that the failure to comply with the s76 procedure and the s77 solvency test are treated as separate offences from the perspective of the directors - Ss76(7) and 77(4)) and, in light of the scheme of the 1993 Act, the failure to include s107 in s81 is legislative oversight only.

At the end of the day, it probably does not matter either from the perspective of the directors, who potentially face personal liability no matter what, or from the perspective of the lenders, who may have a liability to account (either under s81, s18 or pursuant to general principles of dishonest assistance or knowing receipt) depending upon their state of knowledge in relation to the non-compliance. For this reason it is worth reviewing s81 in the context of the scenario under consideration.

As stated, s81(1) provides that the failure to comply with s76 does not affect the validity of the transaction. S81(2), however, makes it clear that issues of liability continue to be relevant, even though the transaction may be valid.

While the section has yet to be considered by the courts, it appears that the reference to "duties" in s81(1) primarily relates to the fiduciary duties of the directors. Lenders or other interested parties are unlikely to be subject to fiduciary duties to the company except as potential constructive trustees as referred to in the section and it is difficult to conceive, in normal commercial situations, of any contractual duties that may be assumed by such parties.

In the situation under review, the directors of each guaranteeing company will owe duties to that company to provide financial assistance only in accordance with s76. In addition the company is likely to be held to owe duties to its shareholders and to its creditors to give financial assistance only in accordance with s76. If those duties are breached, then it is most likely that the directors will be personally liable and whether or not a lender or other interested party is liable as a constructive trustee will depend upon whether it has assisted the breach in circumstances which amount to "knowing assistance" or has received property as a result of the breach in circumstances which would amount to "knowing receipt".

This is a very complex (and continually evolving) area of the law, with, in any particular case, the decision largely turning on the facts. Set out below is a brief summary of the issues and my conclusions, in relation to the scenario under review. Please be aware that this represents a summary only. (For example, where judicial or academic controversy exists I have not always pointed out, or analysed, each of the relevant lines of argument - to do so would have turned this paper into a novel.) It should be regarded in that light only. Finally, in this regard I acknowledge that I have drawn heavily upon (and commend to you) Charles Ricketts' recent article *Banks and Knowing Receipt* -NZLJ, February 1999.

The law in New Zealand has now moved to dishonesty-based knowing assistance and restitution - based knowing receipt.

To establish dishonest assistance, the following requirements need to be met:

(a) a loss must have been suffered through a breach of trust or other form of fiduciary duty;

(b) the defendant must have assisted in the relevant breach ; and

(c) the defendant must have done so dishonestly.

In a commercial context, dishonesty means commercially unacceptable conduct given the particular set of facts and measured as an objective standard. Having said that, it is likely that for dishonesty to be found, the knowledge of the relevant party would have to be of a degree such that one of the first three categories from the *Baden* five-fold categorisation test (being the original test for knowing assistance, seemingly overruled by the Privy Counsel in the *Royal Brunei Airlines* case) is met:

(i) actual knowledge;

(ii) wilfully shutting one's eyes to the obvious;

(iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make.

[(iv) knowledge of circumstances which would indicate the facts to any honest and reasonable man; or

(v) knowledge of circumstances which would put an honest and reasonable man on inquiry and failure to make such inquiry.]

In the situation under review, if the acquisition lenders have made the inquiries I refer to below, it is my view that it could not be said that the conduct of those lenders could be said to be commercially unacceptable and amounting to dishonesty.

To establish restitution-based knowing receipt, the following requirements need to be met:

(a) the existence of a trust or fiduciary duty which is breached by the fiduciary;

(b) the beneficial receipt by the defendant of assets which are traceable as representing the assets of the plaintiff;

(c) knowledge (within the *Baden* levels of knowledge ((i) to (v)) by the lenders that the assets they receive are traceable to a breach of fiduciary duty;

(d) loss suffered as a result of the knowing receipt.

In the scenario under consideration, the requirement set out in (a) is met, as the directors of the guarantor company owe a fiduciary duty to ensure financial assistance is provided only in accordance with the Act. Loss is a question of fact.

Accordingly, the main issues are whether the lenders have beneficially received property as a result of having the guarantee extended to them and whether they can be held to have had the requisite knowledge.

The answer in relation to the first issue is unclear. While there can be no doubt that the lenders received a benefit from the extension of the guarantee, the issue is whether that receipt can be constituted as the receipt of property for the purposes of knowing receipt.

While there is Canadian authority to the contrary, to my mind the better view (and in light of the move by the New Zealand Courts to treat knowing receipt as a restitution-based remedy) is that by receiving the benefit of the guarantee, the lenders will be regarded as having received an equitable property right in the assets of the guarantor.

The critical issue therefore is whether the lenders have the requisite knowledge for a knowing receipt claim to be successful. There can be no doubt that the lenders will be treated as being aware of the duties owed by the directors in respect of the giving of financial assistance. The question is whether they have the required degree of knowledge of circumstances which might relate to any breach of those duties. The circumstances of the transaction itself are sufficient to put the lenders on inquiry. Having been put on inquiry, it is therefore necessary to make those enquiries which an honest and reasonable person would make in order to establish whether or not a breach has in fact occurred.

While the level of inquiry required will vary according to the circumstances, to my mind the following inquiries would be regarded as sufficient in most situations, where uncapped guarantees are being taken:

(a) Requiring a certificate from the directors of each of the relevant companies that any financial assistance provided has been given in compliance with the applicable requirements of the Act and having attached certified true copies of:

  (i) the certificates required under Ss76(4) and 77(2), and

  (ii) a certificate from the company's auditors in relation to the solvency question required to be considered by the directors under s77(2).

(b) Being satisfied that the certificates have been issued on the basis of legal advice which is reasonably believed by the issuer of the certificate to be correct.

(c) Receiving certified true copies of the written consent of all shareholders under s76(1)(a).

Accordingly, provided that:

(a) the enquiries described above are made and the answers received are such that an honest and reasonable person would be satisfied that any financial assistance being given is given in accordance with s76 and in particular, that each company is solvent as required; and

(b) the lenders are in fact so satisfied, taking into account not only the information received as a result of the enquiries described above, but also all other information which they hold in relation to the borrower and guarantor,

I believe that it is most unlikely that a lender would be held to be a knowing receiver or to have dishonestly assisted, even if, in fact, compliance with s76 or s77 did not occur.

As indicated, notwithstanding the above analysis, if Ss76 or 77 are breached, it is most likely that the directors will be personally liable and for this reason (coupled with the propensity of the New Zealand courts to extend the boundaries of knowing receipt) and taking into account the fact that the issue is only likely to be considered in an insolvency situation when, with the benefit of hindsight, the decisions made by the directors may appear questionable, the safest course is for capped guarantees to be taken.

Nature of cap

If the guarantees are to be capped, the next issue is the nature, extent and duration of the cap that applies. In an ideal world (from the perspective of the directors) the cap will be structured such that it equates to the company's net assets from time to time. The problem with this, however, is that the lenders will be structurally subordinated to all other creditors and, in reality, in no better a position than if they had taken a security over the shares in the guarantor only. Such a solution is not palatable, therefore, and arguably does diminish the flexibility intended to be provided by the new provisions. More importantly, it is arguable that a cap at the company's net assets for all time is not required, in that in the case of both Ss77 and 108, the company appears to only be required to comply with the revised solvency test at the point of time "immediately after" the giving of the financial assistance.

On this basis it appears to be possible for the cap on the guarantee to be a fluctuating limit, gradually increasing from the company's original net asset position on the day the financial assistance is given. It could, for example, be formulated as follows:

> The liability of the guarantor under this guarantee shall, to the extent only (and in respect only of the liability that arises as a result) that the granting of this guarantee constitutes the giving of financial assistance for the purpose of or in connection with the purchase by [ ] of shares in [ ], but not in respect of any other liability covered by this guarantee, be limited, at any time ("**particular time**") to an amount equal to the **greater** of:
>
> (1) The net value or worth (taking into account, in terms of s4(4) of the Companies Act 1993 (New Zealand), contingent liabilities) of the guarantor at the time immediately after the giving of the financial assistance (but ignoring, for the purposes of determining that net value or worth, the obligations under this guarantee) less [some margin to ensure solvency, say] NZ$10,000; and
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> (2) An amount equal to the difference between:
>
> (a) the aggregate of the greater of:
>
> (aa) book; and
>
> (bb) market or realisable,
>
> value of each of the assets of the guarantor at the particular time; and
>
> (b) the aggregate of:
>
> (aa) the value at the particular time of obligations remaining pursuant to all the liabilities (taking into account, in terms of s4(4) of the Companies Act 1993 (New Zealand), contingent liabilities) of the guarantor at the time immediately after the giving of the financial assistance to which this guarantee relates (but ignoring for the purpose of determining that, the obligations under this guarantee); and
>
> (bb) NZ$10,000.

The advantage of formulating the cap in this manner is that the revised solvency test is, it is argued, satisfied on day 1 (as required), but thereafter the cap gradually increases , as the creditors in existence at the time the guarantee was given are repaid (ie the structural subordination applies in respect of that limited class of creditors only). Accordingly, provided no other term liabilities exist, the cap will ultimately equal the company's gross assets.

Notwithstanding this, however, unsecured lenders need to understand that, even if this formula is adopted, the best position they will be in is that the guarantee will

be capped at the guarantor's gross assets and that this is the maximum claim they will have in a liquidation, whereas if an uncapped guarantee was taken they would have a claim for the full amount of the liability guaranteed (which could significantly exceed the gross assets of any particular guarantor). One way of addressing this issue, which I have not seen utilised (in that most transactions have been secured), would be for the relevant provision to stipulate that once all of the protected liabilities had been fully repaid, the cap disappeared, the guarantee becoming uncapped from that point in time.

The only other issue that arises in this regard is the period of time that must elapse before the cap begins to increase. The suggested clause envisages the cap beginning to increase immediately (ie the view is taken that it is the creditors in existence at the time the financial assistance is given only that require protection and to whom the lenders need to be structurally sub-ordinated) relying on a literal interpretation of the words "immediately after".

The preferable position to my mind, however, is for the initial cap to not only take account of all liabilities in existence at the time, but also liabilities incurred during an immediately succeeding, but finite, period, such as 3 months.

There are two reasons for this:

(a) Some practitioners argue that such a view is required to be taken for the directors to be satisfied that the requirements of s4(1)(a) are met in relation to the relevant transaction. I am not convinced at the logic of this and believe it reflects confusion as to the analysis that is being undertaken. However, given the risk that a court might share in this confusion and, more importantly, in light of the interpretation that has been placed on the words "immediately after" in another context (as referred to in (b) below) I do not propose to develop the relevant arguments here.

(b) More importantly, in an unreported decision, *Rural Log & Lumber Limited v Tuck M45196-19 July 1996*, a master of the High Court held that the words "immediately after" in the context of s267(1) (b) of the 1955 Act (which referred to the company being able to pay its due debts "immediately after" the charge was given) did not constrain the relevant analysis to one particular moment in time, but rather the issue fell to be considered in line with the established law on "being able to pay due debts" , that is considering the immediate past and the foreseeable future.

Accordingly, a finite period should be included before the cap begins to increase and I believe that 3 months is appropriate in this regard (being a period equivalent to a financial quarter), but would not be adverse to a longer period. Obviously, in such a situation, the lenders would wish to consider including appropriate covenants purporting to restrict the amount, nature and term of liabilities that may be incurred by the guarantor during that period.

Conclusion

To summarise. The 1993 Act introduces a permissive financial assistance regime. However, because of ambiguity in terms of the inter-relationship of certain sections of the Act, the conservative approach in the common cross guarantee situation is for the liability of each member of the guaranteeing group to be capped to its net assets at the

point in time immediately after the financial assistance given (or its minimum net assets during a finite period), but with the cap being structured in such a fashion that, over time, it increases as liabilities in existence at the time the financial assistance is given (or incurred during the relevant period) and which are taken into account in calculating that net asset position, are repaid.

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