LEGAL UPDATE

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BANKING LEGAL UPDATE

2 August 2018

GUARANTEES AND DISTRIBUTIONS

BACKGROUND

In April 2017, the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland published a paper titled 'Guidance on Realised and Distributed Profits under the Companies Act 2006' (the "**Paper**"). It was suggested in the Paper that a subsidiary guaranteeing the debt of a parent or fellow subsidiary without receiving an appropriate fee might, as a matter of law, involve a distribution of assets to its members.

The provision of guarantees and third party security by subsidiaries to secure the indebtedness of its parent or a fellow subsidiary is commonplace, due to the fact that creditors of a parent company often require guarantees and securities from its subsidiaries in order to give lenders access to the assets of the subsidiaries themselves, rather than just the assets of the parent company. Hence, the publication of the Paper raised sufficient concern at a practical level for the Law Society of England and Wales to release a note in June 2018 (the "**Note**") in response to clarify the position with regards to a guarantee (and transactions having a similar effect such as a third party charge) given by an English company in the context of a financing transaction. In essence, the Law Society of England and Wales covered the following key points in their Note:

(a) A guarantee given in a 'normal financing transaction' cannot constitute a distribution.

(b) The directors of a subsidiary must act in accordance with their fiduciary duties owed to the subsidiary in approving the giving of a guarantee. One such duty is that the directors must exercise their powers in the best interests of the subsidiary itself, rather than in their interests of the group as a whole. The directors are also to properly take account of the interests of the subsidiary in giving a guarantee so as to reduce the risk of it being set aside in the event of insolvency of the subsidiary as a transaction at an undervalue.

(c) In addition to the above rules, the directors of a subsidiary have to consider the further requirement that the guarantee satisfies the rules concerning distributions.

This article expounds on the key points highlighted by the Law Society of England and Wales in their Note and briefly considers the potential implications in the Singapore context.

WHAT IS A NORMAL FINANCING TRANSACTION?

The Law Society of England and Wales explained that a 'normal financing transaction' is classified as 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 that therefore a claim is unlikely to be made on the guarantee.

DIRECTORS' DUTIES AND INSOLVENCY LAW

The Law Society of England and Wales also highlighted in the Note the rules to consider in relation to the giving of a guarantee.

First, 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.

The main consideration for the board of a subsidiary when considering whether a guarantee should be given to a creditor of its parent company or fellow subsidiary as the debtor company in a financing transaction is whether the guarantee is likely to be called. This would largely depend on the ability of the debtor company concerned to repay or refinance the credit. The board of directors of the subsidiary would have to accordingly consider the actual and prospective financial condition of the debtor company concerned and the likelihood that it will be able to repay or refinance the credit when required. 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 or ought to be available to it at that time. The question is, therefore, whether the board of the subsidiary can conclude, in good faith and on reasonable grounds, that the debtor company receiving the credit is likely to be able to repay or refinance it when due.

Secondly, the Law Society of England and Wales specified that 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, it may take the view that it is appropriate to enter into the guarantee without charging a fee as in facilitating the parent company's access to financing by giving the guarantee, the subsidiary receives other benefits from giving the guarantee. Such benefits might, for instance, include the subsidiary 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.

Further, the board of a subsidiary would also have to properly take account of the interests of the subsidiary in approving a guarantee, as otherwise the guarantee may constitute a transaction at an undervalue and be at risk of being set aside in the event of the subsidiary's insolvency.

The considerations promulgated in the preceding paragraphs ensure that the directors of the subsidiary properly consider the interests of the subsidiary when deciding whether or not to enter into a guarantee.

CAN A GUARANTEE BE A DISTRIBUTION?

The Law Society of England and Wales stated in the Note that 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. This may amount to a distribution but only if:

(a) the intention is that the guarantee will be, or viewed objectively is likely to be, called; and
(b) the subsidiary does not receive appropriate value for assuming that contingent liability.

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.

IMPLICATIONS FOR SINGAPORE

The discussion of whether a guarantee given by a subsidiary to support the debt of its parent or fellow subsidiary amounts to a distribution in the United Kingdom is instructive. This is because it is also commonplace in Singapore for financing to a borrower to be secured on a group basis, and this may also be relevant in the context of other corporate transactions including debt restructurings. Hence, the same issue may potentially arise in the context of a similar guarantee given by a Singapore company. In addition to considering the existing statutory restrictions under the Singapore Companies Act for the provision of guarantees and securities by companies, the issues raised in the Note, in particular on the directors' fiduciary duties and commercial benefit consideration in the granting of a guarantee and third party security, is also a useful reminder to financial institutions and directors alike when considering the requirements for guarantees to support intra-group indebtedness in financing transactions.

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