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The Commercial Realities of Section 151 of the Companies Act 1985 and Contractual Illegality: Anglo Petroleum Ltd v TFB (Mortgages) Ltd [2008] 1 B.C.L.C. 185

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Introduction

The prohibition against a company giving financial assistance in relation to the acquisition of its own shares is penal and the company can be fined, and any of its officers in default can be fined or imprisoned. In *Anglo Petroleum Ltd* the Court of Appeal considered the interaction between that penal provision and contractual illegality and whether giving financial assistance could render unenforceable credit agreements and securities which had enabled the financial assistance to be given.

Background

Even by the standards of commercial decisions the factual matrix was complex. On February 23, 2001 Anglo Petroleum Ltd (“APL”), the first defendant, had borrowed £15m from TFB Mortgages Ltd (“TFB”), the claimant, via a credit agreement repayable after six months. APL and TFB also entered into a security agreement which charged APL’s assets and property portfolio for repayment of the loan, while S, an individual and the second defendant, guaranteed APL’s obligations to repay the loan.

Three months before the credit agreement, on November 15, 2000, Repsol (APL’s parent company) and APL had entered into what was referred to as a “compromise agreement” whereby APL agreed to pay Repsol £6m immediately and £9m six months later in return for release from its remaining debts to Repsol of £30m: in addition, APL granted Repsol a charge over its property portfolio to secure the £15m. On the same date a company, K, had agreed to buy APL’s entire share capital for £1 (“the SPA”): under the terms of the SPA, K guaranteed APL’s performance of its obligations under the compromise agreement with Repsol, which guarantee was secured by a charge by K to Repsol over APL’s shares sold under the SPA.

APL paid the £6m immediately as required under the compromise agreement. On February 22, 2001, the day before the credit agreement, APL notified TFB that a condition of the SPA was that the £30m of loans owed by APL to Repsol was to be compromised by payment of part, with the final balance to be paid off from the proceeds of the loan by TFB to APL. £9m of the loan was duly used by APL to make early payment of the outstanding sum due to Repsol. This notification was significant because it formed the basis of APL’s subsequent argument that TFB was aware of the purpose of the loan, namely to pay off the balance of APL’s debt to Repsol.

On November 9, 2001, TFB demanded from APL repayment of the outstanding sums due under the credit agreement and appointed administrative receivers over APL’s assets and on December 7, 2001 demanded payment by S of the same sums under the guarantee.

There were three actions: (i) and (ii) were actions brought by TFB against APL to recover debts due under the credit agreement and against S to enforce the guarantee, (iii) was an action brought by APL claiming damages from TFB on the ground that the security agreement was in breach of s.151 of the 1985 Act. APL and S defended the actions brought by TFB on the basis that the credit agreement was void due to illegality since the loan moneys had been used by APL

to provide financial assistance for the purchase of its own shares. The issues of whether the loan moneys had been used by APL in contravention of s.151 and, if so, whether the credit transactions were as a result unlawful were determined by Peter Smith J. ([2006] EWHC 258).

The Law

Section 151(1) provides in essence that: “where a person is acquiring or is proposing to acquire shares in a company, it is not lawful for the company or for any of its subsidiaries to give financial assistance directly or indirectly for the purpose of that acquisition before or at the same time as the acquisition takes place.” Section 151(2) provides that: “where a person has acquired shares in a company and any liability has been incurred (by that or any other person), for the purpose of that acquisition, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of reducing or discharging the liability so incurred.” Section 151(3) provides that if a company acts in contravention of the section, it is liable to a fine, and every officer of it who is in default is liable to imprisonment or a fine, or both.

Section 152(1) defines “financial assistance” as including financial assistance given by way of guarantee or security or any other financial assistance given by a company the net assets of which are thereby reduced to a material extent or which has no net assets. Section 152(3)(a) provides that: “a reference to a person incurring a liability includes his changing his financial position by making an agreement or arrangement (whether enforceable or unenforceable, and whether made on his own account or with any other person) or by any other means”. Finally, s.153(1) provides that: “s.151(1) does not prohibit a company from giving financial assistance for the purpose of an acquisition of shares in it or its holding company if (a) the company’s principal purpose in giving that assistance is not to give it for the purpose of any such acquisition, or the giving of the assistance for that purpose is but an incidental part of some larger purpose of the company, and (b) the assistance is given in good faith in the interests of the company.”

The mischief at which s.151 is aimed is that: “the resources of the target company and its subsidiaries should not be used directly or indirectly to assist the purchaser financially to make the acquisition. This may prejudice the interests of the creditors of the target or its group, and the interests of any shareholders who do not accept the offer to acquire their shares or to whom the offer is not made.” (Arden L.J. in *Chaston v SWP Group Plc* [2003] 1 B.C.L.C. 675, at para.31).

First Instance Decision

APL’s arguments before Peter Smith J on financial assistance took two routes. In route 1, APL argued that by entering into the compromise agreement and the associated charge with Repsol, APL incurred liabilities and thereby gave financial assistance for the purpose of K’s purchase of its shares since by borrowing money from TFB to pay the debt due to Repsol, APL gave financial assistance for the purpose of discharging liabilities incurred for the purpose of the acquisition of its shares; since TFB knew the purpose of the loan it was not entitled to enforce it. In rejecting route 1, the judge held that the giving of security by APL to TFB was not financial assistance under s.151 and that TFB had no knowledge that the loan was being used to replace securities which were financial assistance.

Route 2 argued that the guarantee given by K under the SPA and the charge over APL’s shares were liabilities incurred by K for the purpose of its acquisition of APL’s shares so that APL’s repayment of its outstanding indebtedness to Repsol amounted to giving financial assistance to discharge K’s outstanding liabilities to Repsol. The judge also rejected this argument on the ground that the repayment of APL’s debt was not financial assistance to K but a commercial transaction for the purpose of benefiting APL; in any event TFB was not aware of any underlying illegality.

The Court of Appeal

Toulson L.J. described APL's arguments as ingenious and skilfully deployed but upheld the judge's decision. At para.[44] he said that in his view: "the commercial reality is that APL and Mr Sutton are seeking to avoid their liabilities to TFB, for what was in essence a straightforward commercial loan, by a strained reading of the statute." Although he acknowledged that the making by APL of early repayment of its obligations to Repsol so as to relieve K as purchaser from those obligations could amount to giving financial assistance, the reality was that there were bona fide reasons for the repayment. In relation to the security agreement, Toulson L.J. at para.[51] held that if the repayment was lawful then it was equally lawful for APL to provide security to assist that repayment.

The court also considered whether, if APL had given financial assistance, the effect would have been to make the credit and security agreements illegal and unenforceable. At para.[83] Toulson L.J. said that it was hard to see how public policy would be served by invalidating a contract which had not been unlawful in its terms and which a reasonable person in the position of TFB would have seen as an ordinary, innocuous commercial transaction. He added that it was also hard to see how public policy would be served by stretching the principle that ignorance of the law was no excuse so as to attribute to the party seeking to enforce the contract an unrealistic knowledge that the other party intended to act illegally. In the circumstances it had been reasonable for TFB to see the loan to APL as an ordinary commercial loan made in the course of its business and there was no good reason why public policy should have required TFB to investigate whether the proposed use of the loan would amount to a breach of s.151. At para.[84] the judge said that the law would be out of touch with reality if it deemed TFB to have had knowledge that the proposed use would be a breach, particularly as the effect of s.151 would have been far from obvious to a lawyer, let alone to a party in the position of TFB. Finally, even if s.151 had been potentially engaged, if APL had itself been aware of a problem it would have had the possibility of using the whitewash procedure under s.155.

Conclusion

The irony of APL arguing that it had provided financial assistance contrary to s.151 was not lost on the judges, particularly in the reference to use of the whitewash procedure to cure any breach of s.151. Although the court accepted that the circumstances might have amounted to APL giving financial assistance to K for the purchase of its own shares, the argument that the credit and security agreements with TFB were unenforceable flew in the face of the commercial reality of the transactions and offended the fundamental principle that public policy will justify holding a contract as illegal only where there was a genuine purpose to be achieved. APL's argument was ingenious but legally flawed.