McCann FitzGerald

Briefing
Intra-Group Transactions: Some Recurring Legal Issues for Directors

INSTITUTE OF DIRECTORS IN IRELAND

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The Companies Act 2014 (the "**Act**") includes detailed provisions concerning the establishment and operation of groups of companies. This briefing covers some material legal issues for directors to consider arising from the relationship of companies in a group

Overview

Directors of a company within a group should be aware of some recurring issues that arise in the context of dealings by and between such companies, and of the practical steps that should be taken when dealing with group relationships.

The starting point remains the principle in the *1896* case of *Salomon v Salomon & Co*: every company is a distinct legal entity, separate from its members and having its own legal rights and liabilities. In certain limited circumstances the "corporate veil" (*ie* the separate legal identity of a company) can be 'pierced' so that two or more companies are treated as a single entity. Therefore, directors ought to manage a company so that it does not inadvertently assume liability for obligations of another group company.

When are Companies within a Group?

The definitions of subsidiary/parent company for general purposes of company law are complex and the Act retains wider definitions of subsidiary undertaking/ parent undertaking for the purposes of financial statements. In practice, it can be difficult to determine whether a subsidiary/ parent relationship exists; indeed, a company may be a subsidiary of more than one parent.

- *Parents*: broadly, an undertaking (whether or not incorporated in Ireland) is a *parent* to a subsidiary if it meets any one or more of these criteria:
  - (a) it holds a majority of the voting rights in the undertaking;

(b) it is a member of the undertaking and has the right to appoint/remove majority of the members of its board;

(c) it has the right to exercise "dominant influence" over the undertaking due to provisions in the subsidiary's constitution or a "control contract" (such as a shareholders' agreement);

(d) it is a member of the undertaking and controls alone, under an agreement with other shareholders/members, a majority of its voting rights; or

(e) it has the power to, or actually exercises, dominant influence or control over the undertaking, or both of them are managed on a unified basis.

- *Subsidiaries*: again broadly, for the purposes of the Act a company is another's *subsidiary* if it satisfies any one or more of these criteria certain information in the heading (including the company name, the type of meeting and the place, date and time at which it was held);

(a) where one company or its nominee holds more than half in nominal value of the other's voting shares, or more than half in nominal value of the other's "equity share capital";

(b) where one company is a member of the other and controls the composition of the latter's board, ie where one company has unrestricted power to appoint/remove all or a majority of the other's directors; and

(c) where one company is a subsidiary of the other's subsidiary.

Duties of Directors

The general fiduciary duties of a director include the duties to:

- act in good faith in what the director considers to be the interest of the company;
- act honestly and responsibly and exercise reasonable care, skill and diligence;
- not to use company property for his or her own use, unless permitted by the company's constitution or the members in general meeting;
- promote the success of the company and exercise independent judgement; and
- avoid conflicts of interest and declare an interest in proposed transactions or arrangements.

A director owes his or her duties to the relevant company, and not to the corporate group as a whole. However, frequently in practice the interests of each company in a group are similar. Nonetheless, difficulties can arise for people who are directors of a number of group companies that don't have common interests.

The Act provides expressly that a director can have regard to the interests of any member that appointed him or her, so long as the interests of that member do not conflict with the primary duty to the company itself. Such a 'nominee director' should undertake his or her role extremely carefully and may have to resign from affected positions if a conflict of interest becomes significant.

Intra-Group Transactions

Directors need to pay particular attention to certain types of transaction within a group.

Distributions

A company must not make a distribution except out of profits that are available for the purpose. If a dividend is paid otherwise than in accordance with the Act, that dividend is unlawful and any shareholder receiving that dividend, who has reasonable grounds to believe that such payment is unlawful, is liable to repay it. Also, directors of the distributing company who are party to the payment are exposing themselves to a personal liability to the company.

The Act specifies a strict procedure to determine the financial statements that are to be used to calculate distributable reserves as well as the process by which distributions may be made. Also, accounting rules determine whether in various specific circumstances a profit is "realised" and can therefore be part of distributable reserves.

Transfers at Book Value

Companies frequently seek to transfer assets to other group members at book value (which in a particular case may, quite lawfully, be substantially less than market value). Prior to the Act there was some legal uncertainty as to whether such a transaction constituted a distribution (UK law in this area had been clarified many years ago).

Now the Act provides that, where a company has distributable profits and makes a relevant transfer of an asset at *book value* (and where market value is higher), the company makes a distribution, but the value of the distribution is zero. If the transfer is at less than *book value*, the amount of the distribution is the difference between book value and the consideration received, and the company must have distributable reserves to cover this.

In addition to confirming that the transfer at book value may be made because distributable profits exist, directors should consider:

- their fiduciary duties (discussed above), all the more so if there is any possibility that the company is experiencing financial stress;
- whether the proposed transfer could constitute the giving of financial assistance for the purpose of an acquisition of shares in the company or its parent company; and
- various insolvency-related provisions in the Act (such as whether the transfer is an unfair preference of a creditor). Typically, time periods in the Act within which a transaction may be challenged is much longer where a transaction is with a connected entity (such as a group company).

Points of Good Practice

Generally:

- Try not to have common directors on all group company boards: consider using non-executive directors.
- Ensure every director is aware of his or her duties.
- Hold separate board meetings for each group company, with a company-specific agenda.
- Keep a detailed minute of each board meeting (and note the corporate benefit of each transaction to that particular company).
- Document every transaction.
- Be cautious if a parent company is asked to approve the actions of the board of a subsidiary: avoid giving directions to a board of a subsidiary.
- Declare interests in group companies and check if conflicted directors can vote or take other governance actions.

In an intra-group transaction:

- Be clear as to which company is which party to the transaction (it is prudent to include company registered numbers for certainty).
- Ensure that such a transaction is at 'arm's length', where possible (otherwise, take professional advice).
- Monitor the financial position of the company and, where possible, of any group counterparty as part of the process.

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