Chief Minister's Department

Supplemental Response Paper

Green Paper dated 25 November 2011 proposing amendments to the Companies (Jersey) Law 1991: Proposed amendments 3, 24 and 25

Date: 17 December 2013

SUMMARY OF CONSULTATION

On 25 November 2011 the Minister for Economic Development ("the Minister") published a Green Paper inviting comments on 34 separate proposals for amendments to the Companies (Jersey) Law 1991 ("the Law"), including:

a. An amendment to Article 17, which provides that a private company with more than 30 members shall be treated as if it were a public company (proposed amendment 3).

b. An amendment to the definition of a 'distribution' contained in Article 114, so as to make it clear that any transaction between a company and its members which does not reduce the net assets of the company falls outside its scope (proposed amendment 24);

c. The introduction of a procedure for the ratification of distributions made in contravention of the procedure set out in Article 115, which requires the directors of the company authorising the distribution to make a solvency statement (proposed amendment 25).

The Minister published a summary of the responses to the consultation on 5 February 2013. In relation to proposed amendment 3, the response paper stated that it had been decided to abolish the 30 member limit for a private company altogether.

In relation to proposed amendments 24 and 25, the response paper noted that the responses received had raised a number of issues. These required further reflection and consultation before a final decision was made whether, and in what way, to proceed with those proposed amendments.

Following the publication of the response paper the Minister embarked on further consultation with interested parties in relation to amendments 24 and 25. The scope of this consultation was subsequently extended to include certain issues arising in connection with proposed amendment 3, which were raised by the Jersey Financial Services Commission ("JFSC") after publication of the response paper.

Further written representations were received from two of the major law firms in Jersey (Mourant Ozannes and Carey Olsen) and further advice was also sought from its external advisers (a practising UK barrister and a Professor of Law and Finance at the University of Oxford).

This supplemental paper summarises the responses received during the further consultation. As responsibility for the Law passed to the Chief Minister during the course of 2013, this paper sets out the Chief Minister's final position in respect of each of the three amendments.

Calculation of number of members for change of status to public company (Article 17A) (Proposed amendment 3)

As set out above, the conclusion reached by the Minister following the initial consultation was that the 30-member limit for private companies imposed by Article 17 no longer served any useful purpose and that it could therefore safely be abolished.

However, the JFSC subsequently pointed out that the removal of the 30-member limit would mean that private Jersey companies whose securities are admitted to trade on a market outside the European Union would no longer be treated as public companies by the Law. It was said that this would be undesirable in that it would reduce Jersey's compliance with the International Organisation of Securities Commissions' (IOSCO's) Objectives and Principles of Securities Regulation (in particular Principles 16-21 relating to the disclosure of information to investors, provision of audited financial statements, accounting and auditing standards and the supervision of auditors).

The JFSC suggested that this issue could be addressed by making a further amendment to Article 17 to provide that any private company whose securities are admitted to trade on a regulated market outside the European Union would also be subject to the Law as if it were a public company, or alternatively by amending the definition of a 'regulated market' contained in Article 102(1) so that it also applies to regulated markets outside the European Union. It requested, however, that any such amendment be delayed pending completion of a more general review of Jersey's compliance with the IOSCO Principles, which it intends to undertake in the course of 2013.

Responses

One of the written responses received expressed concern about the suggestion that the definition of 'regulated market' be amended so as to extend to markets outside the European Union. It pointed out that this would seem to require Jersey private companies listed on such an exchange to appoint a Jersey or UK auditor rather than a local auditor who would be much better placed to audit the company.

The other written response agreed with this view and expressed the opinion that it would be better to leave Article 17 unamended. It pointed out that one of the original reasons for the abolition of the 30-member limit arose out of uncertainty over whether the UK Takeover Code would apply to a Jersey private company simply by virtue of the fact that it had more than 30 members and was therefore subject to the Law as if it were a public company. Recent experience, however, suggests that the Takeover Panel does not consider that the Code would apply in such circumstances.

The responses also suggested that it would be sensible to amend the Law so that the 30-member limit could in future be abolished or amended by means of Regulations passed by the States. It was also suggested that in any event an amendment to Article 17A of the Law to extend the scope of that provision to current and former directors and employees of subsidiaries and of other companies in the same group should be made. This was one of the other options outlined in the original Green Paper.

Chief Minister's position

It is recognised that there is a risk that the abolition of the 30-member limit might adversely affect Jersey's compliance with IOSCO Principles. As has been suggested, it may be that this risk could be eliminated by making further amendments aimed at ensuring that companies whose securities are traded outside the EU continue to be treated as public companies. However, it is clear from the responses received that such amendments could themselves have undesirable consequences, and therefore require careful consideration.

In light of this, and of the fact that one of the original reasons behind the proposed amendment appears to have fallen away, it has been decided not to proceed with the abolition of the 30-member limit at present. This matter is intended to be reconsidered once the JFSC has concluded its own review.

It has, however, been decided to introduce a provision into the Law enabling the States to abolish or amend the 30-member limit by Regulations.

Furthermore, the Chief Minister will also proceed with the proposed amendment to Article 17A, so that, in determining whether a company has more than 30 members for the purposes of Articles 16 and 17(2), no account is to be taken of members of the company who are current or former directors or employees of the company, any subsidiary of the company, or any other company in the same group of companies.

The scope of the term 'distribution' (Article 114(2)) (Proposed amendment 24)

As described in the Green Paper, this amendment arose out of a concern amongst practitioners that certain *bona fide* commercial transactions between a company and its members might unintentionally be caught by the very wide definition of a 'distribution' contained in Article 114, and therefore potentially rendered unlawful because the solvency statement procedure set out in Article 115 had not been followed.

The example given in the Green Paper was that of an upstream guarantee, given by a subsidiary to a third party in respect of indebtedness of its parent. Unless there is a probability that it would be called upon, so that it would have to be recognised immediately as a liability in the subsidiary's accounts, the giving of such a guarantee would not affect the net asset position of the company and therefore ought not to be treated as a distribution.

Following the close of the initial consultation the Minister remained unpersuaded that the proposed amendment was in fact necessary. On the current state of the law the risk that a genuine commercial transaction between a parent and its subsidiary, such as the giving of an upstream guarantee, would be treated as a disguised distribution within the meaning of Article 114(1), appears to be negligible.

Furthermore, as noted in the response paper, concerns were expressed that the proposed amendment might have the effect of creating, rather than eliminating, uncertainty over whether certain types of transaction are caught be the definition. It might be argued that the amendment demonstrates that the Jersey legislature intended to include in the definition of a 'distribution' a wide range of transactions between a company and its members, which do reduce the company's net assets. By focusing on the net asset position of the company before and after the transaction, the proposed amendment could prompt the Jersey courts to adopt a stricter approach than that adopted by the English courts, which is to treat a transaction between a company and its members as a disguised distribution only if it is at a gross undervalue which cannot be justified in commercial terms. This approach allows a wide margin of appreciation (see the decision of the UK Supreme Court in *Progress Property Co Ltd v Moorgarth Group Ltd* [2010] 1 WLR 1, which is of persuasive authority in Jersey).

In the course of further consultation with interested parties following the publication of the response paper it was strongly argued that, given the sums of money that can be involved in the transactions under consideration, the proposed amendment was necessary to eliminate any risk, however small, of them being subsequently found to be unlawful.

It further emerged that a related problem potentially arises in connection with intra-group transfers of assets at book value, which had not been raised in the Green Paper. Where the book value of the assets is significantly below their market value, there may be a risk that the transaction could be characterised as a disguised distribution, even though there is no reduction in the company's net assets. In the UK this problem became known as the 'Aveling Barford' problem (after *Aveling Barford v Perion Ltd* [1989] BCLC 626) and was addressed by the introduction of the statutory provisions now contained in section 845 of the Companies Act 2006.

In response to the issues raised it was proposed, as an alternative solution, that the definition of a 'distribution' in Article 114 be left as it is, but that Article 115 be amended so as to provide that its requirements do not apply to a distribution which does not reduce the net assets of the company. It was considered that this approach would achieve the objectives of the original proposal, whilst at the same time avoiding the unintended consequences that might flow from amending the definition of a 'distribution' itself.

Responses

Both of the written responses received during the further consultation supported this solution.

Chief Minister's position

Accordingly, the Chief Minister now intends to proceed with the alternative solution outlined above.

Ability to ratify a distribution (Article 115) (Proposed amendment 25)

The requirement laid down in Article 115 that the directors of a company make a solvency statement prior to authorising any distribution of the company's assets to its members exists for the protection of the company's creditors. However, as described in the Green Paper, many practitioners consider that this requirement has created a 'trap for the unwary'. There is anecdotal evidence to suggest that the requirement for a solvency statement is sometimes overlooked.

In addition, it occasionally happens that a transaction between a company and its members subsequently has to be re-characterised as a distribution. If no solvency statement was made (as is likely) prior to the transaction, it would be an unlawful distribution.

The consequences of making an unlawful distribution are serious. The directors who authorised the distribution may be personally liable to restore to the company the amount of the distribution. Furthermore, under Article 115A shareholders who received an unlawful distribution can also be liable to repay it (or pay the company an amount equivalent to the value of the distribution if it was made otherwise than in cash) if they knew or had reasonable grounds for believing that the distribution was unlawful.

As matters stand, the Law does not provide a mechanism whereby an unlawful distribution can be validated or ratified retrospectively. It is understood that there is a legal solution to this problem, however, it is understood that this solution is far from perfect and is not always suitable in the circumstances.

The original proposal set out in the consultation paper envisaged that the directors would be permitted to ratify an unlawful distribution by making a retrospective solvency statement. Concern was expressed, however, that this would undermine the significance of the requirement for a prior solvency statement, and thereby dilute creditor protection. In effect, such a statement would no longer be a pre-condition of validity for a distribution.

The point of making the validity of a distribution conditional upon the making of a solvency statement is to ensure that the directors address their minds properly to the financial position of the company before they pay away the company's money. By permitting solvency statements to be made retrospectively the proposed amendment risks increasing the chances of a distribution being made at a time when the company is in fact insolvent. Although the original proposal does not envisage that the retrospective procedure would be available in such circumstances, creditors of the company may nevertheless still be prejudiced, as they would be left having to pursue remedies against the directors and/or shareholders (many of whom may be resident in other jurisdictions).

The Minister indicated in the response paper that he was sympathetic to the argument that the legislation in its current form created an unnecessary 'trap for the unwary' and that it agreed in principle that there should be a procedure for retrospectively validating a distribution made in contravention of Article 115, subject to appropriate safeguards. Further

reflection and consultation was, however, considered desirable before a decision was made as to how best to achieve this.

In the course of the further consultation that took place after the publication of the response paper, interested parties were invited to comment on two alternative solutions. The first of these involved a court-based procedure akin to that found in Article 6 of the Limited Liability Partnerships (Jersey) Law 1997 (as amended by the Limited Liability Partnerships (Amendment of Law) (Jersey) Regulations 2013). Pursuant to such a procedure the company would have to make an application to the Royal Court for an order that retrospectively validates the distribution and relieves the directors and shareholders from any liability to repay it.

It was envisaged that, as a pre-condition to the making of such an order, the Royal Court would have to be satisfied as to the solvency of the company both at the date of the hearing and at the date on which the distribution was made, and, if the distribution was made less than 12 months prior to the hearing, that the company was likely to remain solvent for the remainder of that period.

The other alternative proposed was a procedure modelled on that in Parts 18B and 18C of the Law, which deal with mergers of companies and continuance outside Jersey. In broad outline, such a procedure would require the company to notify its creditors of the making of a retrospective solvency statement. Upon receiving such notification the onus would then be on the creditors of the company to make an application to court within a specified period of time (say 21 days) for an order setting aside the retrospective solvency statement e.g. that the company was not solvent at the time of the distribution, or that there is some other reason why it would be contrary to the interests of justice for the directors and/or shareholders to be relieved of liability to repay the distribution.

Responses

Both of the written responses received expressed concerns that these alternative options were unnecessarily onerous. They reiterated a preference for the original proposal set out in the Green Paper. One of the responses stated that, if the original proposal was no longer acceptable, both alternatives should be made available. This response also suggested that the court-based procedure should not be subject to a solvency requirement (at least not a solvency requirement at the time the unlawful distribution was made).

The other response suggested that the concerns raised in relation to the original proposal might be overcome by requiring that a solvency statement made in respect of an earlier, unlawful distribution be prospective, i.e. the directors would have to state their belief that the company would remain solvent and continue to be able to carry on its business for a period of 12 months from the date of the new statement.

Chief Minster's position

The Chief Minister has carefully considered these responses. It has been decided not to proceed by drafting an amendment in the form originally proposed in the Green Paper. The reasons for this are as follows.

First, the effect of the amendment in its original form would be to permit the directors of a company to 'self-ratify' a breach of their statutory duty without appropriate scrutiny. As a matter of principle, this seems anomalous.

Second, it has not been established that the amendment as proposed in the Green Paper does not carry with it a real risk of weakening creditor protection, and a related risk of reputational damage for Jersey as a jurisdiction.

In this regard, it is noted in passing that no other jurisdiction which requires a solvency statement as a pre-condition for the validity of a distribution by a company to its members, appears to have adopted the approach envisaged by the original proposal. Indeed, one such jurisdiction (New Zealand) imposes criminal, as well as civil, liability for a failure to make the required statement prior to authorising a distribution.

Finally, the amendment in its original form would create a disparity between the rules applicable to companies and the rules applicable to LLPs, which were revised only very recently. Partners in a LLP would be subject to a more onerous regime for validating unlawful distributions than the directors of a company. There do not appear to be any good reasons why this should be so. Concerns about creditor protection apply to companies and LLPs with equal force.

In order to address the problem that was identified in the Green Paper, it has been decided to introduce into Part 17 of the Law a court-based procedure for the ratification of distributions made in contravention of Article 115. The advantage of such a procedure is that it provides an element of scrutiny, which is absent from the original proposal.

Furthermore, although there has never been anything to suggest that directors authorise unlawful distributions as a matter of course, if further incentive were needed to remind directors of this particular requirement of the Jersey Law, the need for a court procedure to ratify an unlawful distribution might go some way towards providing it.

The new procedure will allow a company, which has made a distribution in contravention of Article 115, to make an application to the court for an order that a distribution shall be deemed for all purposes to have been lawfully made, notwithstanding the fact that it was made in contravention of Article 115.

The threshold conditions for the making of such an order should be as follows:

a) At the time of the hearing of the application the company is able to discharge its liabilities as they fall due; and

b) The company was able to discharge its liabilities as they fell due immediately following the date on which the distribution was made; and

c) if the distribution was made less than 12 months prior to the hearing, there are reasonable grounds for believing that the company will continue to be able to discharge its liabilities as they fall due and carry on its business until the expiry of a period of 12 months from the date on which the distribution was made.

It is envisaged that, in cases where the solvency of the company is not in any doubt, and it is clear that the failure to make a solvency statement was an innocent oversight by the directors, an order should generally be made as a matter of course. Accordingly, the new provisions will be worded in mandatory terms requiring the court to make an order if the threshold conditions are satisfied, unless it considers for some other reason that it would be contrary to the interests of justice to do so.

There is a concern to ensure that the new procedure is not unnecessarily onerous. Accordingly, it is envisaged that an application for an order ratifying an unlawful distribution may, unless the court orders otherwise, be made without notice to any other person (such as the company's creditors).

It is considered that it would be undesirable for the new provisions to prescribe the circumstances in which the court ought to order that notice of the application be given to any other person. This will depend entirely on the particular facts and circumstances of the case, and it is therefore best left to the good sense of the judge dealing with the application. In considering this issue the court may, for instance, find it helpful to have regard to the practice developed in relation to applications under Articles 62-63 of the Law for confirmation of a reduction of capital.

- End of Supplementary Response Paper -