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### Easing the Prohibition of Financial Assistance rules in Malta- Recent Developments

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#### Introduction

The giving of financial assistance by a company for the purchase of its own shares was introduced into Maltese law by the Companies Act in 1995, which replaced the Commercial Partnerships Ordinance originally promulgated in 1962.

Drawing extensively on the UK rules, the Maltese law provisions were introduced to bring Maltese law in line with developments in company law theory and practice in Anglo-Saxon jurisdictions in this regard, primarily curbing abusive practices in takeovers and acquisitions by protecting the company's capital and, as a result, safeguarding its shareholders, creditors and employees. Whilst the motivation for introducing such rules were well-intentioned, the absence of flexibility in the implementing provisions translated into a categorical prohibition of any form of leveraged buyout ("LBO") structuring in respect of Maltese companies, throwing a spanner into the works of many merger and acquisition transactions.

#### The Prohibition

The prohibition contained in Article 110 of the Companies Act provides that *"it shall not be lawful for an undertaking ... to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of an acquisition or subscription ... of or for any shares in the company or its parent company."* Article 110 also lays down a general prohibition relating to the acquisition by a company of shares in its parent company.

The prohibition is rendered inapplicable by way of exception in the following cases:

- (i) employee share incentive schemes (introduced to conform with Article 23(2) of the Second EC Company Law Directive- Directive 77/91/EEC); and
- (ii) investment companies with fixed share capital involved in transactions involving the acquisition of that company's fully paid up shares by another company.

Both exceptions are made subject to the requirement that in either case, the transaction does not reduce the company's net assets below the value of its issued share capital and its undistributable reserves.

Although Article 110 is modelled almost *ad verbatim* on Article 54(1) of the UK Companies Act, 1948, curiously, the significant changes adopted by the UK's Companies Act, 1985 were omitted by the Maltese



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legislator. Thus, for instance, the exception relating to “*banks and other financial institutions in the normal course of their business*”, which is also covered by Article 23 (2) of the EC’s Second Company Law Directive, was omitted from the text of the Maltese Companies Act. However it appears that this exception would apply in any event in Malta as a result of the doctrine of direct effect of EU law in the respective Member States.

A proper definition of financial assistance in the Maltese Companies Act is conspicuous by its absence. Indeed, the provision simply refers to *loans, guarantees or the provision of security* as forms of assistance that would constitute financial assistance for the purposes of the Act. Whilst these are unquestionably forms of financial assistance, the absence of an exhaustive list of forms of financial assistance has smothered the development of compliant structures by practitioners. Besides, the absence of any significant local case law in this regard does little to help introduce any degree of certainty. This definitional vacuum is unlike the UK Companies Act which provided a comprehensive definition in Article 152(1) of the 1985 Act, now designated as Article 677 of the 2006 Act.

Another interesting observation is that the Act does not directly address the consequences of a breach of the prohibition. However, the fact that the provision states that it shall be unlawful for a company to provide financial assistance, the “unlawfulness” would essentially result in the legal nullity of any transaction which purported to breach the prohibition.

### The 2008 Amendment

Despite the noble intentions underlying the introduction of the prohibition of financial assistance provision within the original text of the Companies Act 1995, the rigidity of the outright prohibition has caused much frustration to local and international practitioners dealing with corporate finance and merger and acquisition transactions involving Maltese companies, attracting harsh criticism from these camps.

Ultimately it was an initiative on a European level, in the form of Directive 2006/68/EC which led the Maltese legislator to implement an amendment to the Maltese Companies Act, introducing a degree of flexibility to the outright prohibition laid down in Article 110. The amendment, which was included in the Accountancy Profession Act and Other Laws (Amendment) Act of 2008 (Act No. IX of 2008) and which gained the force of law on the 1<sup>st</sup> October 2008, took the form of a new sub-article (4) to Article 110. The amendment effectively rendered the financial assistance prohibition inapplicable to private limited liability companies- as opposed to public companies- subject to the satisfaction of certain prescribed conditions and formalities. The exclusion of public companies from this exception is ostensibly based on the principle of subjecting public companies to heightened level of control in the interest of their shareholders and stakeholders generally.

The result of the amendment to Article 110 is a more workable provision which has sought to strike a balance between protecting private companies and their stakeholders from potential mischief of eroding the company’s share capital whilst allowing a degree of flexibility in circumstances where the target company’s financial situation would not be adversely affected by the leveraging of its assets.



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### The Applicable Conditions and Formalities

In order for private companies to provide financial assistance to any other person for the purpose of acquiring or subscribing to any shares in the company or its parent company, all of the following conditions must apply:

- (i) The Board of Directors must, by means of an affirmative vote of a majority of all the directors holding office at the time of the resolution, and after taking into account the financial position of the company and their fiduciary obligations towards the company, pass a resolution to authorise the granting of financial assistance by the company for a specific transaction;
- (ii) The Directors' resolution must be affirmed by an extraordinary resolution taken by the shareholders of the company; and
- (iii) a declaration in a prescribed form, confirming that the aforementioned conditions have been complied with, must be signed by the directors of the company and filed with the Registrar of Companies prior to the contemplated grant of financial assistance by the company.

An interesting observation stems from the fact that whereas the exceptions pertaining to employee share schemes and investment companies with fixed share capital are expressly qualified by the requirement that such transaction must not reduce the company's net assets below the value of its issued share capital and its undistributable reserves, the new sub-article (4) is not so qualified. That being said, the fact that the directors are required to consider the company's financial situation before authorising the granting of financial assistance, the transaction's impact on the company's net assets would invariably be addressed by the directors before formally approving such transaction.

The 2008 amendment has brought a long-awaited relaxation of the outright prohibition, providing private companies with a clear procedure to comply with in circumstances where the directors felt that such financial assistance is in the company's best interest and in line with their fiduciary duties towards the company. Indeed, the changes were considered long-overdue, particularly when considering that private ship-owning companies regulated by the Merchant Shipping (Shipping Organisations – Private Companies) Regulations were provided with a clear procedure to derogate from financial assistance rules since the introduction of the said regulations in 2004.

The amendment has, however, also attracted a fair degree of criticism. Those who advocate the prohibition's total abolition opine that the mere introduction of a formal procedure to derogate from the general prohibition in certain cases, and only in respect of private companies, does not go far enough. It is argued that the prohibition's *raison d'être* has been lost in time and there are now other laws (*inter alia* the rules regulating directors' fiduciary duties and the distribution of profits) that do a better job of addressing the concerns that originally gave rise to the need for such prohibition, thus rendering the prohibition redundant in practice.

Interestingly, the scope of Directive 2006/68/EC is not limited solely to private companies. It also caters for derogations from the financial assistance prohibition in relation to public companies. The directive, however, allows Member States complete flexibility as to whether or not to incorporate such rules into their legal systems, thus excluding the possibility of applying such provisions in Malta on the basis of the



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doctrine of direct effect. The stance taken by the Maltese legislator of not including any reference to public companies in the 2008 amendment provides a clear signal that any such amendment is not likely in the foreseeable future.

### Shortcomings

One of the main shortcomings of the 2008 amendment is that it failed to introduce any legal clarity in relation to the consequences arising from a breach of the prohibition. As a result, the Maltese Companies Act provisions setting out the prohibition continue to stand somewhat sterile in their failure to directly address the consequences of such breach. In practice, tainted transactions are considered to be unenforceable *ab initio*, and the directors of the company also face personal liability on the basis of the general and fiduciary duties owed towards the company's stakeholders. The UK provisions take the director's liability a step further by exposing them to criminal sanctions and possible imprisonment in case of default.

Besides, the amendment also failed to address the doubt caused by the use of the term 'undertaking' in Article 110 as opposed to the term 'company'. The existence of this doubt results from the fact that the term *undertaking* is defined in the Act as "a body corporate or unincorporate which carries on a trade or business". On the basis of this definition it could be argued that if a company does not carry on a "trade or business", then it does not qualify to be classified as an undertaking for the purpose of Article 110. Consequently there appears to be a weakness in the drafting which was not duly addressed as part of the 2008 amendment.

### Conclusion

Whilst it is clear that the introduction of the procedure set out in sub-article (4) to Article 110 of the Maltese Companies Act has brought a degree of flexibility to the previously unworkably rigid financial assistance prohibition rule under Maltese law, it is clear that the Maltese legislator's stance has remained considerably more conservative than that taken in other EU jurisdictions such as Italy, Belgium and the United Kingdom. Besides, the introduction of the said procedure has only passed the buck onto the company's directors, who now find themselves placed under substantial pressure in the context of leveraged buyout transactions, seeing that they are effectively charged with initiating the proverbial green light for any proposed financial assistance transactions. This may clearly be an unenviable predicament for directors to be in, particularly when faced by deal-makers mounting pressure on the board of directors to have such transactions approved, since the directors' interest in conducting the necessary due diligence and obtaining the desired levels of comfort before approving such transactions may mistakenly be interpreted as recalcitrance on their part.

All being said, it is only time that will tell to what extent the amendment to the outright prohibition has served to accommodate the structuring of such transactions. It is also time that practitioners and directors



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require to develop clearer parameters of comfort that will serve to pave the way towards complying with the legal requirements necessary for the approval of such transactions.

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