IS A GUARANTEE BY A SUBSIDIARY FOR THE DEBTS OF A PARENT COMPANY A DISTRIBUTION UNDER THE COMPANIES ACT - *(Mark McKee, Partner)*

In terms of Section 2 (1) of the Companies Act, CAP 42:01, a distribution is defined as follows:

"Distribution" in relation to a distribution by a company to a shareholder, means-

- *(a) the direct or indirect transfer of money or property, other than the company's own shares, to or for the benefit of the shareholder; or*
- *(b) the incurring of a debt to or for the benefit of the shareholder, in relation to shares held by that shareholder, and whether by means of a purchase of property, the redemption or other acquisition of shares, a distribution of indebtedness, or by some other means, but shall not include a distribution of assets to shareholders upon a winding up;"*

For a guarantee by a subsidiary of its parent company's debt to qualify as a *"distribution"*, it must consequently either:

- be a direct or indirect transfer of property or money to or for the benefit of the parent; or
- be the incurring of a debt to or for the benefit of the parent, in relation to shares held by the parent.

The giving of a guarantee by a subsidiary for a debt of its parent company is however in itself not a transfer of money or property (this only happens later) and consequently such a guarantee will not qualify as distribution under the first limb of the definition.

This then begs the question of whether such a guarantee qualifies as a distribution under the 2nd limb of the definition.

In terms of the 2nd limb of the definition, a debt incurred by a company will only be a distribution where:

- it is incurred to or for the benefit of a shareholder; and
- *in relation to shares held by that shareholder*

The words *"relation to shares held by the shareholder"* require that the debt must be incurred to or for the benefit of the shareholder in its capacity as a shareholder. This, in our view, means that for a debt to qualify as *"distribution"* it must be incurred to or for the benefit of the parent company only because of the parent's shareholding in the subsidiary (and for no other reason). Where however a debt is incurred by the subsidiary in an arms-length commercial arrangement which will be beneficial to the subsidiary there is a good argument that this is not incurred simply because of the shareholding relationship and consequently is not caught by the 2nd limb of the definition. This interpretation was upheld in the New Zealand case of *JL Vague and G Macdonald and DML resources Limited (in liquidation) v C W McCarthy and others HC CIV-2001-404-2403* when dealing with a substantially similar definition in the New Zealand Companies Act. The Court in that case went further to require that for a debt incurred by the subsidiary to qualify as a distribution it had to be demonstrated that there was a loss to the company and a corresponding gain by the shareholder. The latter test would obviously not be satisfied where the guarantee given by a subsidiary brings a commercial, or some other benefit, to the subsidiary. There is also a further argument that the parent does not receive a benefit or gain in the sense that if the guarantee is called and paid, the parent, in terms of common law, then becomes indebted to the subsidiary in such amount.

In summary, it is our opinion that where there is reasonable commercial basis for a subsidiary guaranteeing the debts of its parent company, such guarantee does not qualify or constitute a distribution under the Companies Act.