International legal practice

Key contacts

Chris Randall
Partner - London
chris.randall@nortonrose.com
+44 (0)20 7444 3642

Jill Gauntlett
Partner - London
jill.gauntlett@nortonrose.com
+44 (0)20 7444 3580

Capital maintenance - the Companies Act 2006

September 2008

Summary

The doctrine of capital maintenance - i.e. that a company must receive proper consideration for shares that it issues and that having received such capital it must not repay it to members except in certain circumstances - is a fundamental principle of English company law. The Companies Act 2006 makes a number of important changes to the rules relating to capital maintenance and, in line with the deregulatory objectives of the Act, a number of the statutory requirements in this regard have been relaxed. This briefing discusses some of the key areas of law which have developed in relation to capital maintenance and explains the recent deregulatory measures which have been introduced.

Maintenance of capital

English law has developed the doctrine of capital maintenance with the aim of ensuring that a company with a share capital must obtain proper consideration for the shares that it issues and must not return funds so received to its members, except in certain circumstances.

The general principles were originally developed by the courts and since then have been increasingly superseded by statute, most notably Part V of the Companies Act 1985 (CA 1985) and, from the applicable dates of implementation, Parts 17, 18 and 23 of the Companies Act 2006 (CA 2006).

The doctrine of maintenance of capital underpins the legal rules in the following important areas:

- payment of dividends or other distributions to shareholders;
- reduction of a company's share capital and/or reserves;
- prohibition on the provision by a company of financial assistance for the purchase of its own shares; and
- a company's redemption or purchase of its own shares.

The CA 2006 makes a number of important changes to the rules relating to capital maintenance and, in line with its deregulatory objectives, a number of the statutory requirements have been relaxed. In particular, with effect from 1 October 2008, the rules on unlawful financial assistance will no longer apply to private companies (in most circumstances) and private companies will also be allowed to reduce their share capital without the need to go to court. Amongst other things, the reforms present a good opportunity for groups of companies to rationalise the capital structure of group members to remove dividend blocks which may prevent subsidiaries paying up dividends to their parent company.

Distributions

The provisions relating to distributions in the CA 1985 have broadly been restated in Part 23 CA 2006 which came into force on 6 April 2008 and applies to distributions made on or after that date. It continues to be the case that a dividend or distribution to members cannot be made except out of profits available for the purpose by reference to "relevant accounts" and Part 23 sets out the rules relating to permissible distributions.

In addition, in relation to distributions in kind (arising for example, on the transfer of an asset intra-group from a subsidiary to its parent or a sister subsidiary at less than market value), the existing City market practice that arose after the decision in *Aveling Barford Ltd v Perion Ltd [1989] BCLC 626*, has been confirmed in section 845 CA 2006

so that:

- if a company is transferring an asset where the amount or value of the consideration is not less than (i.e. is equal to or more than) its book value and the company has profits available for distribution, the transfer can proceed. The transfer will be treated as a distribution but the amount of the distribution is taken to be zero. For the purposes of section 845, the company's distributable profits will be treated as being increased by the amount, if any, by which the actual consideration for the asset exceeds its book value; and
- if a company is transferring an asset for less than book value, the amount of the distribution is calculated by reference to the asset's book value. The distribution will be deemed to be the difference between the book value of the asset and the amount or value of actual consideration given for it. Provided that the company's distributable profits are equal to or exceed the amount of the difference, the distribution will be lawful.

Other points to note in relation to distributions:

- A further restriction applies to distributions by public companies which does not apply to distributions by private companies. A public company may only make a distribution if, following the distribution, the amount of its net assets is not less than the aggregate of its called-up share capital and undistributable reserves (section 831(1) CA 2006). The effect of this is that a public company must, when calculating the amount available for distribution, reduce the amount of its net realised profit available for distribution by the amount of its net unrealised losses (see section 2.31 of The Institute of Chartered Accountants in England and Wales' Technical Release TECH 01/08).
- The statutory rules on distributions, with a couple of stated exceptions, are subject to the common law. Under the common law, a company cannot lawfully make a distribution out of capital. Accordingly, even if the "relevant accounts" show sufficient profits available for distribution, the directors must consider whether, subsequent to the relevant balance sheet date, the company has suffered losses which might affect the company's ability to make a distribution.
- When deciding whether to make a distribution, the directors must consider their general duties, including their duty to promote the success of the company under section 172 CA 2006.

Reduction of share capital

Companies reduce share capital for a number of reasons. One example is where a company wants to make a distribution to shareholders and needs to create sufficient distributable profits to do so. Reserves to enable a distribution to be made can be created by a reduction or cancellation of the company's share capital or certain reserves, such as share premium.

From 1 October 2008, the CA 2006 introduces a new procedure for private companies to be able to reduce their share capital by a special resolution supported by a solvency statement given by all the directors. This new procedure does not require court approval of the reduction and introduces an ability for the private company concerned to reduce its capital in any way which was previously only possible if the company was an unlimited company. Whilst the solvency statement required is similar to the CA 1985 "whitewash" statutory declaration for financial assistance, unlike the "whitewash" procedure and the continuing requirements in connection with a private company purchase of own shares out of capital, no auditors' report is required and creditors have no right to object to the reduction.

The solvency statement is a written statement signed by every director stating that they are of the opinion that:

- at the date of the statement, there are no grounds on which the company could be found to be unable to pay its debts; and
- the company will be able to pay or discharge its debts as they fall due for the next 12 months or, if the company is to be wound up in the next 12 months, in full within 12 months of commencing the winding up.

It will not be permissible to qualify a solvency statement in any way and directors will commit a criminal offence if they make a solvency statement without having reasonable grounds for the opinions expressed in it.

The nature and extent of the work which will have to be done to ensure that directors have reasonable grounds for giving a solvency statement will depend on the circumstances. The directors will need sufficient information before them to enable them to identify the company's current liabilities (including contingent and prospective liabilities) as well as those which have to be discharged over the next 12 months. Precisely what the directors need to consider is likely to depend on the circumstances of the company. In the case of a trading company, the directors may consider

it appropriate to prepare a memorandum as to the company's working capital over the next 12-18 months on the basis of certain reasonable assumptions and "stress-test" this model by varying certain of the assumptions within a reasonable range.

Whilst there is no requirement in the CA 2006 for an auditors' report to support a solvency statement, in certain situations the directors might consider it prudent to seek advice or comfort from the company's auditors to be able to demonstrate that they have reasonable grounds for the opinions expressed in the solvency statement and that they have adopted sensible processes to reach their conclusions.

Subject to anything to the contrary in the shareholder resolution relating to the reduction or anything in the company's articles, if a private company reduces its share capital using the new route, then the reserve will be treated as a realised profit and so be distributable. In the case of a court-approved reduction, the reserve will be treated as a realised profit unless the court orders otherwise.

In relation to reductions of capital confirmed by the court, the CA 2006 broadly restates the procedure contained in the CA 1985, subject to certain minor amendments which come into effect on 1 October 2009. The court-approved route is available to both public and private companies, unlike the new out of court procedure referred to above which only applies to private companies.

If a company follows the court-approved reduction process, then, once a shareholder resolution has been passed reducing the company's share capital, the company may seek confirmation of that resolution from the court. Unless the court directs otherwise, all creditors of the company as at a date fixed by the court are entitled to object to the reduction. In such cases, the court process requires a list of creditors, but, in practice, will usually dispense with this requirement if the company can show that all of its creditors have consented to the reduction or that, to the extent that such consent has not been obtained, an adequate form of creditor protection is in place. Commonly accepted methods of creditor protection include:

- setting aside cash funds in a blocked account;
- providing a bank guarantee; and
- providing an undertaking to the effect that the amounts arising from the reduction of capital will be paid into a reserve and will not be repaid to shareholders to the extent that creditors have not been paid off or consented.

Where a creditor list is required, it is for a creditor bringing an objection to the reduction to show that there is a real likelihood that the proposed reduction will put at risk the due discharge of its claim or debt.

Unlimited liability companies can continue to reduce their capital in any way and thereby create distributable reserves without the need for a court sanction or to follow the solvency statement procedure introduced by the CA 2006. However, the relative unattractiveness of introducing companies with unlimited liability into corporate groups may mean that their use becomes less frequent.

The table attached to this briefing summarises the relative merits of the different routes which a company may follow to reduce its share capital.

Financial assistance

The prohibition on the giving of financial assistance by private companies in most circumstances will be repealed with effect from 1 October 2008. As a result of this repeal, from 1 October 2008, there will no longer be any statutory whitewash procedure. However, the prohibition on the giving of financial assistance by public companies contained in the CA 1985 will be retained until 1 October 2009, when it will be replaced by similar provisions in Chapter 2 of Part 18 CA 2006. In addition, a private company will continue to be unable to give financial assistance for the acquisition of shares in its (direct or indirect) public holding company.

Notwithstanding the repeal of the statutory rules, a transaction which might once have constituted unlawful financial assistance still needs to be considered in the light of the following general company law principles which must continue to be taken into account:

- the transaction must be in the best interests of the company ("likely to promote the success of the company for the benefit of its members" in accordance with section 172 of the CA 2006); and
- the transaction must not breach the rules on distributions or otherwise constitute an illegal reduction in the capital of the company.

In addition, the validity of the transaction must not be vulnerable to challenge as a transaction at an undervalue for the purposes of section 238 of the Insolvency Act 1986.

As far as the first point is concerned, the board minutes recording the directors' approval of the transaction concerned should identify the commercial benefit which the transaction confers and which enables the directors to conclude that the transaction promotes the company's success. If this conclusion is reinforced by an approval of the transaction by the company's shareholders, then this should reduce or eliminate the risk of a challenge by the company or shareholders based on a breach of duty by the directors. However, the risk of such a challenge will remain if the company is insolvent, or is threatened by insolvency in consequence of the transaction concerned.

The board also needs to give detailed consideration as to whether the transaction might amount to an unlawful reduction of capital. If the transaction involves an outright transfer of assets to or for the benefit of the shareholders of the company, then it may constitute a distribution. The statutory rules on distributions referred to above will have to be complied with if the transaction is gratuitous, or it involves a transfer at less than book value (if the company has distributable reserves) or less than fair market value (if the company does not have distributable reserves). If the transaction, being one which is with or for the benefit of shareholders, involves a gift, a loan, a guarantee, an indemnity or the creation of security, then it might constitute an unlawful reduction in the company's capital if it reduces the company's net assets. This will be the case if a provision needs to be made in the company's books when the transaction is entered into and the company has insufficient distributable reserves to cover that provision.

Whether or not a provision has to be made is primarily a decision for the directors, acting in accordance with their general duties to the company. They will have to assess the likelihood of the guarantee being called, the security being enforced or the loan not being repaid (as applicable). There will be no effect on net assets if no immediate accounting provision needs to be made. The amount of detailed information needed by the directors to enable them to assess the situation will depend on factors such as the degree of uncertainty about the likelihood of the event occurring and the potential size of any resulting payment or loss. However, in all cases the directors, in making an informed decision, will need to be satisfied that they have sufficient information about the overall financial situation. In deciding whether or not a provision must be made (and, if they conclude that it must be made, in determining the amount of that provision and the amount of any distributable reserves that may be available to cover it), the directors may, in some circumstances, wish to consult the company's auditors. The board minutes of the meeting at which the directors consider these issues should record the fact that the directors have considered whether the transaction will result in a reduction of net assets and, if so, the amount of the company's distributable profits.

Purchase of own shares

The general rule is that a limited company may not acquire its own shares by purchase, subscription or otherwise, except as permitted. Part 18 CA 2006, which comes into effect on 1 October 2009, brings together the current methods by which a limited company can acquire its own shares and section 658 CA 2006 prohibits the acquisition by a limited company of its own shares except in accordance with the provisions of that Part. One advantage of a company reducing its share capital by purchasing its own shares is that the purchase price for the shares concerned may exceed the amount of capital that those shares represent.

The provisions of Part 18 will simplify some restrictions, including in the following ways:

- a company will have the power to purchase its own shares unless there is a specific prohibition or restriction contained in its articles of association. Currently a company (public or private) wishing to purchase its own shares must have authority in its articles to do so; and
- a private company wishing to purchase its shares out of capital will no longer need specific authorisation in its articles. In addition, the directors will no longer have to make a statutory declaration before a solicitor or commissioner for oaths in connection with the purchase out of capital. A private company will be able to make a purchase out of capital if it complies with the requirements of Chapter 5 of Part 18 which include that the directors have given a solvency statement (similar to the statutory declaration currently required under the CA 1985) supported by an auditors' report as to the reasonableness of such a statement. A shareholder resolution will also still be required.

A new requirement will be that where the shares are cancelled following their purchase (which they must be unless they are held as treasury shares), the company must notify the registrar of companies of the cancellation and provide a statement of capital.

Conclusion

The key changes to the capital maintenance rules introduced by the CA 2006, being the repeal of the statutory prohibition on the giving of financial assistance by private companies and the new out of court reduction of capital procedure for private companies, are to be welcomed. Whilst it will be interesting to see how market practice

develops in relation to the new out of court reduction procedure available to private companies, the changes should simplify many transactions, shorten transaction timetables and reduce costs.

Relative merits of the different routes for returning share capital to shareholders

Reduction of share capital supported by a solvency statement	**Reduction of share capital approved by the court**	**Reduction of share capital by reregistration as an unlimited company**	**Purchase of own shares out of capital**

• Only available to private companies.
 	
• Procedural requirements more straightforward (special resolution of shareholders and a solvency statement) making this route quicker and less costly.
 	
• Possibility of criminal sanctions for making a solvency statement without reasonable grounds may mean that directors seek additional comfort before giving such a statement or simply prefer to adopt the court approval route.
 	
• No requirement for the company to obtain creditor consent or to put in place creditor protection measures. Accordingly, this route might be preferred in the following circumstances:
  • where a company has a very large number of creditors and it would be complex and costly to put in place creditor protection measures; or
  • where the number or size of any creditors are unpredictable (eg because of litigation or a large pension deficit) .
 	
• The reserve arising is treated as a realised profit and is therefore
	• Procedural requirements more onerous therefore may take longer (typically not less than 8 weeks) and be more costly.
	
	• No requirement for the directors to opine on the ability of the company to pay its debts. Accordingly, this route might be preferred in the following circumstances:
	  • the company is highly leveraged;
	  • the company's business is undergoing difficulties or has recently suffered a set-back;
	  • there are material risks or uncertainties connected with the company's business; or
	  • one or more of the directors is less involved in the running of the business than the others (making him reluctant to give the solvency statement) and the other directors want him to remain on the board rather than resign.
	
	• The distributability of the reserve arising may be wholly or partly restricted pursuant to the court
		• Procedural requirements less onerous than the out of court route and the court approved route.
		
		• No criminal sanctions and no requirement to opine on the ability of the company to pay its debts.
		
		• No issues as to distributability of resulting reserves.
			• Only available to private companies.
			
			• Procedural requirements more straightforward than a reduction approved by the court but slightly more onerous than a reduction supported by a solvency statement.
			
			• Possibility of criminal sanctions for making a solvency statement without reasonable grounds.
			
			• No requirement for the company to obtain creditor consent or to put in place creditor protection measures but creditors (or members who have not supported the special resolution) can apply to the court to block the purchase.
			
			• No issues as to distributability of resulting reserves.
			
			• Useful in circumstances where none of the reduction of capital routes are possible because the company has insufficient share capital and share premium to cover the amount of capital to be returned.

distributable immediately (to the extent not needed to eliminate existing losses).	order.

Disclaimer

This publication is written as a general guide only. It is not intended to contain definitive legal advice which should be sought as appropriate in relation to a particular matter.
Extracts may be copied provided their source is acknowledged.

Website: http://www.nortonrose.com
Contact our 24 hour London switchboard:
Tel +44 (0) 20 7283 6000
Fax +44 (0) 20 7283 6500

© Copyright Norton Rose LLP 2009. All rights reserved.

Jersey

COMPANIES (AMENDMENT No. 4) (JERSEY) REGULATIONS 200-

Report

Explanatory Note

These Regulations would amend the Companies (Jersey) Law 1991.

Regulation 1 is an interpretation clause.

Regulation 2 widens the meaning of the expression "open-ended investment company". A company would now come within this category if its sole business is to invest in securities or other property, and its articles provide that substantially all of its shares are to be redeemed or purchased at the request of the holders at prices not exceeding their net asset value.

Regulation 3 amends Article 74(2) of the Law. That paragraph enables a company's members to authorize or ratify an act or omission of a director that is in breach of his or her duties. The members may only do so if the company is solvent after the act or omission concerned. The effect of the amendment is to make it clear that the point of time at which the test must be satisfied is that immediately after the act or omission.

Regulation 4 amends Article 114(2) of the Law. That paragraph at present provides that, for the purposes of Part 17 of the Law (which Part controls distributions by companies), the expression "distribution" does not include reductions of capital by extinguishing or reducing a shareholder's liability on shares that are not paid up.

The effect of the amendment is to provide instead that the expression does not include a distribution by a reduction of capital that is made in accordance with Part 12 of the Law.

Regulation 5 amends Article 181 of the Law. That Article relates (inter alia) to the liability of a person to contribute in a creditors' winding up the amount of money paid to him or her in respect of the redemption or purchase by a company of its shares. The liability at present arises if the payment has not been made wholly out of profits

available for distribution, or out of a fresh issue of shares for the purpose of the redemption or purchase. The effect of the amendment is to replace references to payments from these sources by references to payments made unlawfully.

Regulation 6 provides for the citation of the Regulations, and that they will come into force on 1st   200-.

COMPANIES (AMENDMENT No. 4) (JERSEY) REGULATIONS 200-

Arrangement

Regulation

1 Interpretation 5
2 Article 1 of the Companies (Jersey) Law 1991 amended 5
3 Article 74 amended 5
4 Article 114 amended 5
5 Article 181 amended 6
6 Citation and commencement 6

COMPANIES (AMENDMENT No. 4) (JERSEY) REGULATIONS 200-

Made *[date to be inserted]*

Coming into force *[date to be inserted]*

THE STATES, in pursuance of Articles 2B, 85A, 115B, 181 and 220 of the Companies (Jersey) Law 1991, have made the following Regulations –

1 Interpretation

In these Regulations, "the Law" means the Companies (Jersey) Law 1991.

2 Article 1 of the Companies (Jersey) Law 1991 amended

In Article 1 of the Law, for the definition "open-ended investment company" there shall be substituted the following definition –

" 'open-ended investment company' means a company –

(a) the sole business of which is to invest in securities or other property of any description; and

(b) the articles of which provide that its shares, or substantially all its shares, are to be redeemed or purchased at the request of the holders at a price or prices not exceeding the net asset value of those shares.".

3 Article 74 amended

In Article 74(2)(b) of the Law, for the words "after the act or omission" there shall be substituted the words "immediately after the act or omission".

4 Article 114 amended

For Article 114(2)(c) of the Law there shall be substituted the following sub-paragraph –

"(c) any reduction of capital made in accordance with Part 12; or".

5 Article 181 amended

(1) For Article 181(1)(b) of the Law there shall be substituted the following sub-paragraph –

"(b) the payment was not made lawfully; and".

(2) For Article 181(2) of the Law there shall be substituted the following paragraph –

"(2) In this Article, the amount of a payment that has not been made lawfully for the purpose of the redemption or purchase is referred to as the 'relevant payment'.".

6 Citation and commencement

(1) These Regulations may be cited as the Companies (Amendment No. 4) (Jersey) Regulations 200-.

(2) These Regulations shall come into force on 1st 200-.