KEY FACTS COMPANY LAW

4th edition

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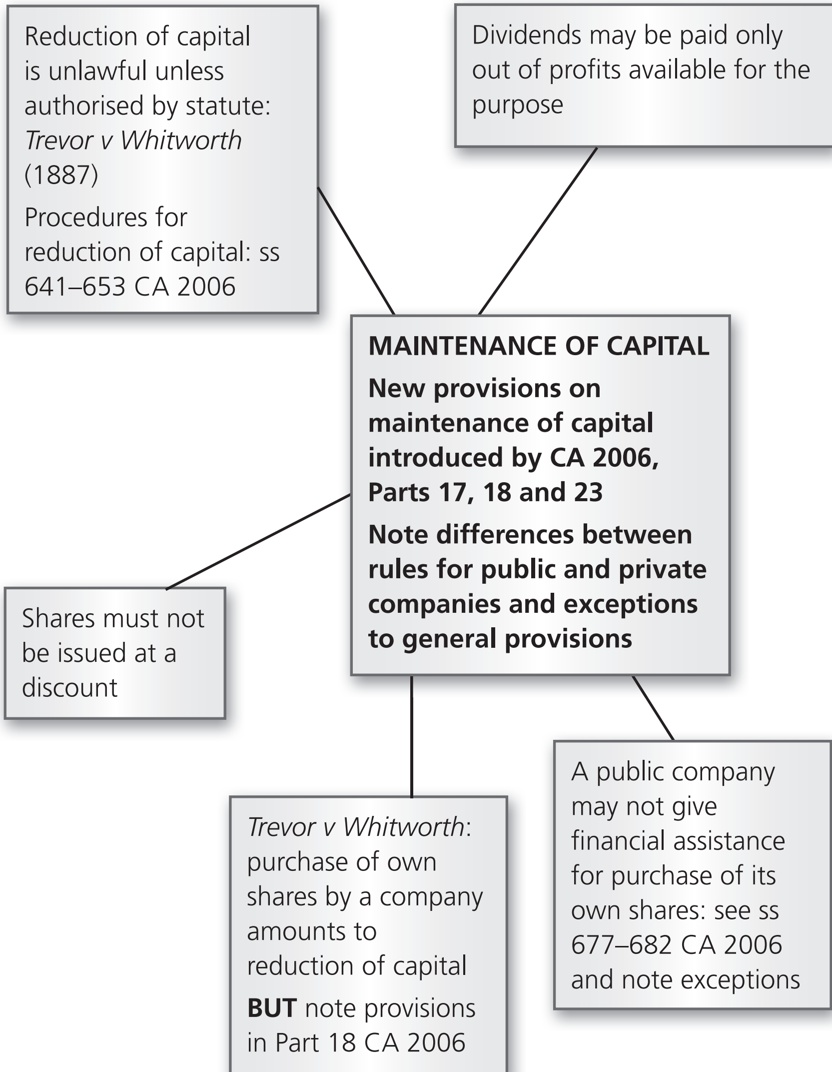
Maintenance of capital



8.1 General principles

1. The principle on which the rules relating to maintenance of capital are based is that a company should not pay share capital back to shareholders.
2. Historically the capital contribution of shareholders was intended to provide some security for the company's creditors and the law therefore lays down strict and complex rules in relation to the reduction of capital.
3. Share capital now often plays a relatively minor role in the financing of companies and the rules provide little protection for creditors.
4. In response to recommendations made in the course of the Company Law Review, the CA 2006 has made some significant changes in this area, which are described below. The statutory provisions are now contained in Parts 17, 18 and 23 CA 2006.
5. Share capital in this context means the money raised by the issue of shares and bears little relationship with the net worth of the company as a going concern.
6. There is no minimum share capital requirement for a private company; a public company must have a minimum share capital of at least £50,000.
7. Capital can be spent (and lost) in the course of carrying on the company's business, but it cannot be returned to members as this would amount to a reduction of capital with the result, in theory, that creditors would have less security.
8. In the case of a company not in liquidation, payments to shareholders can only be made out of profits, usually by way of dividend.
9. There are a number of rules that have developed to ensure that a company's capital, in the narrow sense used here, is maintained. These are described below. However, there are circumstances when a company will wish to reduce its capital and ss 641–653 of the Companies Act 2006 set out the procedures by which this may be done.

8.1.1 The main rules relating to the maintenance of capital

Relevant provision: CA 2006	General rule	Main exceptions
Part 17 Chapter 10	A company may not reduce its share capital: *Trevor v Whitworth* (1887)	A private company may reduce its capital by special resolution supported by solvency statement: s 641(a) Any company may reduce its share capital by special resolution confirmed by the court: s 641(b)
Part 23, s 831(1)	Distributions, including dividends may only be made out of profits available for the purpose	Except as provided for in Part 23
s 580(1)	Shares may not be allotted at a discount	
s 593	In the case of a public company, if shares are issued for a non-cash asset, the asset must be valued before allotment	
s 658	A limited company may not purchase its own shares except in accordance with Part 18	s 659 – purchase of own shares is not prohibited in a 'reduction of capital duly made'; in pursuance of an order of the court s 692 – a private company may purchase its own shares out of capital A public company may only purchase its own shares out of distributable profits

s 678	A public company may not give financial assistance for the purchase of its own shares	s 678 – it is not unlawful where the principal purpose in giving assistance is not for the acquisition of shares, but is for a larger purpose of the company, and the assistance is given in good faith in the interests of the company
s 677	Defines financial assistance	s 681 sets out certain transactions that do not amount to unlawful giving of financial assistance

8.2 Reduction of capital

8.2.1 The general rule

1. The general rule that a reduction of capital is unlawful unless authorised by statute was established in *Trevor v Whitworth* (1887).
2. The statutory provisions relating to reduction of capital are contained in ss 641–653 CA 2006. There are important differences in the provisions relating to private companies on the one hand and public companies on the other.
3. Under s 641:
   - any company may reduce its share capital by special resolution confirmed by the court: s 641(1)(b);
   - a private company limited by shares may reduce its share capital by passing a special resolution supported by a solvency statement: s 641(1)(a) and ss 642–644.
4. Thus, a private company may seek confirmation of the court but is no longer obliged to do so, while a public company can only reduce its capital with the authority of the court.

8.2.2 Private companies: the solvency statement

1. The solvency statement must be made not more than 15 days before the special resolution to reduce capital is passed.

2. Section 643 lays down requirements with respect to the solvency statement which must state *inter alia* that each of the directors is of the opinion that there is no ground on which the company could be found unable to pay its debts. If the directors make a solvency statement without having reasonable grounds for the opinion expressed, each director will be guilty of an offence.
3. The solvency statement, a statement of capital and the special resolution must be sent to the Registrar: s 644.

8.2.3 The role of the court

1. The court's main concern in approving reductions of capital is the protection of creditors, and the legislation provides opportunities for creditors to object (s 646).
2. In deciding whether to confirm a resolution for the reduction of capital the court must:
   - be assured that the interests of existing creditors are protected;
   - ensure that the procedure by which the reduction is carried out is correct (*Scottish Insurance Corporation Ltd v Wilsons & Clyde Coal Co Ltd* (1949)).
3. The court will not sanction a scheme if it is unfair. It must consider whether the scheme is fair and equitable between shareholders of different classes and between individual shareholders of the same class.
4. The court must be satisfied that the shareholders have received sufficient information to exercise an informed choice in voting on the special resolution.

8.3 Dividends

1. Distributions (which cover certain payments made to shareholders, including dividends) may be made only out of profits available for the purpose (s 830(1)). Procedures for this are laid down in Part 23 CA 2006. The Act lays down complex rules by which distributable profits are calculated.
2. Dividends may be declared as provided in the articles. Usually a declaration will be recommended by the directors and approved by the shareholders at the annual general meeting. Articles may also provide for an interim dividend to be declared by directors.

3. Members have a right to receive a dividend once it has been declared.
4. A public company cannot make a distribution which would result in the amount of the net assets becoming less than the aggregate of its called-up share capital and undistributable reserves (s 831(1)).
5. Directors who authorised an unlawful distribution may be liable to repay the money to the company.
6. Under s 847 a shareholder may be liable to repay an unlawful dividend if the shareholder knew or had reasonable grounds for believing that the distribution was made in contravention of Part 23.

8.4 Issues at a discount

1. Shares can be issued at below their market value, but members must pay at least the full nominal (or par) value for their shares. Section 580(1) provides that shares may not be allotted at a discount. (See also *Ooregum Gold Mining Co of India Ltd v Roper* (1892).) Section 580(2) CA 2006 provides in the event of contravention of this rule that the allottee must pay the amount of the discount plus interest.
2. If shares are paid for by a non-cash asset or assets, the rule may be difficult to enforce.
3. In the case of public companies, s 593 requires that if shares are issued for a consideration other than cash, the consideration must be valued before allotment. The section provides also that the valuer's report must be made to the company during the six months before the allotment and must be sent to the allottee.
4. In the case of private companies, there is no requirement that non-cash assets should be formally valued (*Re Wragg* (1897)).

8.5 Purchase by a company of its own shares

1. *Trevor v Whitworth* (1887) established the principle that a company may not purchase its own shares – this would amount to a reduction of capital.
2. This principle was inconvenient in a number of situations, especially for private companies, and some exceptions were introduced.

3. Section 658 CA 2006 now contains a provision to the effect that a limited company must not acquire its own shares except in accordance with the provisions in Part 18 of the Act. Part 18 lays down a complex set of rules enabling purchase by a company of its own shares. Section 658(2) provides that if a company acts in contravention of this section an offence is committed by the company and every officer in default and the purported acquisition is void.
4. Section 690 allows a limited company to purchase its own shares (including redeemable shares) subject to:
   - the provisions of Part 18 Chapter 4 of the Act, and
   - any restrictions in the company's articles.
5. In the case of public companies such purchases must be made out of distributable profits.
6. Private companies only may purchase their own shares out of capital, subject to any restriction in the articles and to safeguards for creditors (s 709).
7. A company can, subject to certain conditions, issue redeemable shares:
   - a public company can only issue redeemable shares if authorised by its articles;
   - a private company does not require authorisation by the articles, but the articles may limit or prohibit the issue of redeemable shares.
8. A public company can only redeem shares out of distributable profits or out of the proceeds of a fresh issue of shares made for the purpose of redemption. A private company may redeem shares out of capital.
9. Note: a company may not own shares in its holding company (s 136 CA 2006).

8.6 Financial assistance for purchase of own shares

8.6.1 CA 2006: the rules for public companies

1. The law in this area has been significantly changed by the Companies Act 2006. The general rule that a company may not give financial assistance for the purchase of its own shares has been abolished for private companies and applies now only to public companies.

2. Section 677 provides that unlawful financial assistance may occur when a company:
   - lends or gives money to someone to buy its shares;
   - lends or gives money to someone to pay back bank finance raised to buy its shares;
   - releases a debtor from liability to the company to assist the debtor to buy its shares;
   - guarantees or provides security for a bank loan to finance a purchase of its shares;
   - buys assets from a person at an overvalue to enable that person to purchase its shares (*Belmont Finance Corporation v Williams Furniture Ltd* (*No 2*) (1980)).
3. Section 678(1) provides that it is unlawful for a public company or its subsidiary to give financial assistance for the acquisition of shares in that company. The provision of such financial assistance is a criminal offence (s 680).
4. Under s 678(2) certain transactions are not unlawful. Financial assistance is not prohibited if:
   - it is given in good faith and in the interests of the company; and
   - the acquisition of shares is not the principal purpose, but is 'an incidental part of some larger purpose'.

   This section has caused great difficulty in practice and the House of Lords decision in *Brady v Brady* (1988) restricted its use.
5. In recent cases the courts have given effect to the 'commercial reality' of the situation and in a number of cases have found on that basis that financial assistance had not been given: for example, *MT Realisations Ltd v Digital Equipment Co Ltd* (2003); *Anglo Petroleum v TFB (Mortgages) Ltd* (2006); and see also *Chaston v SWP Group* (2002).
6. Under s 681 certain situations are not covered by the provisions above, including:
   - a distribution by way of a dividend or in the course of a winding up;
   - an allotment of bonus shares;
   - reduction of capital under Part 17 CA 2006;
   - anything done in the course of a compromise or arrangement under Part 26;
   - anything done under s 110 Insolvency Act 1986;
   - anything done under an arrangement between the company and its creditors under Part 1 Insolvency Act 1986.

7. Further exceptions, which apply subject to certain conditions, are set out in s 682. These include:
   - where the lending of money is part of the company's ordinary business and the money is lent in the ordinary course of business;
   - provision by the company of financial assistance for the purposes of an employees' share scheme;
   - loans to employees, other than directors, to enable them to acquire shares in the company or its holding company.

8.6.2 Remedies and sanctions

These are as follows:

- a prohibited loan will be void;
- the company and its officers may be fined;
- directors may be liable to the company for misfeasance and breach of trust;
- persons receiving funds who knew or ought to have known of the directors' breach of duty will be liable as constructive trustees (*Belmont Finance Corporation v Williams Furniture Ltd (No 2)* (1980)).