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INTERNATIONAL CORPORATE LAW AND FINANCIAL MARKET REGULATION

# Perspectives in Company Law and Financial Regulation

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# 16

## Some aspects of capital maintenance law in the UK

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### I. Introduction

The corporate form is used pervasively in the United Kingdom. In 2005 there were 1,968,000 private companies ('Ltd')[1] and 11,600 public companies ('Plc')[2] on the companies' register.[3] In the year 2004–2005 there were 332,700 new private companies incorporated and 1,100 public companies.[4] In 2005, 43,600 companies were struck off the register and 4,200 were wound up.[5] The rate of new incorporations has been significant: it is estimated that since 1997 new incorporations have risen by over 60% and the number of foreign firms incorporating in the UK has more than quadrupled.[6] A salient feature of UK company law is ease of access to the corporate form. No barriers of any substance are placed in the way of obtaining corporate status.[7] There is a 'free market' rationale for ease of incorporation – provided parties are aware that they are dealing with

[1] This is the default category, unless a company adopts the public company form it will be a private company: Companies Act 2006, s. 4 (hereafter 'the 2006 Act').

[2] A company must explicitly provide for public company status in its constitution: 2006 Act, s. 4(2).

[3] See DTI, *Companies 2004–2005, Report for the year ended 2005* (DTI, October 2005), Table A2.

[4] See DTI, *Companies 2004–2005*, (note 3, above), Table A2, 14.

[5] The Companies Act 2006, sections 1000–1002, enables the regulatory authorities to have a company struck off the register, normally this is for non-compliance with the regulatory provisions of the Companies Act 2006. This is by far the most common way in which companies are removed from the register. Such companies can be restored to the register: see Companies Act 2006, ss. 1024–34. In 2005, 300 companies were restored to the register (see DTI, *Companies 2004–2005* (note 3, above), Table C1).

[6] Hansard, House of Lords, Vol. 677, at 180 (2006).

[7] The Registrar of Companies offers a one-day incorporation service. It is not uncommon for the large London law firms to incorporate companies in batches so that when the need arises they can take the company off the shelf, hence the common reference to shelf companies. Such companies are treated as 'dormant' companies and are exempted from the regulatory provisions of the 2006 Act until they commence trading; see the 2006 Act, (note 1, above) s. 1134.

a limited liability company they can protect their own interests.[8] To the extent that the corporate form can be abused, control of abusive practices is by means of a liability rule applied *ex post* and by an *ex ante* rule that is designed, for example, to ensure economic viability.[9] Occasionally, UK company law will use a property rule to protect the interests of the *dramatis personae* of company law. One example of this are the provisions on shareholder pre-emption rights,[10] which use a property protection rule, the conferral of a right of pre-emption, rather than a liability rule, that is, an *ex post* legal remedy where a shareholder has been unfairly treated by a particular allotment.[11] Other than in the area of capital maintenance,[12] UK law relies on *ex post* liability rules to curb the misuse of the corporate form, rather than *ex ante* quality control rules.[13]

A second feature of English company law is that it is enabling; that is, it leaves considerable autonomy to the draftsman of a company's constitution as to how the central matters of a company's activities, namely, distribution of profits, allocation of losses, and allocation of control are dealt with.[14] The draftsman of the corporate constitution does not have a completely free hand but there is a larger measure of freedom in drafting a company's constitution that the vast bulk of the Companies Act 2006 would suggest.[15]

[8] See Companies Act 1985, s. 349; Griffin, 'Section 349(4) Of The Companies Act 1985: An Outdated Victorian Legacy', *Journal of Business Law*, (1997), 438. This justification is not without its difficulties: it does not address the issue of involuntary creditors (tort victims) or day-to-day normal trade creditors.

[9] For example, the Insolvency Act 1986, s. 212 (misfeasance proceedings by liquidator), s. 213 (fraudulent trading), and s. 214 (wrongful trading) are all *ex post* sanctions. There is no *ex ante* requirement such as minimum capitalization. See D. Prentice, '*Corporate Personality, Limited Liability and the Protection of Creditors*', in Rickett and Grantham, *Corporate Personality in the 20th Century* (Hart, 1998), Ch. 6.

[10] 2006 CA, ss. 574–593. These implement the Second Directive on Company Law (79/91/EEC), Article 29.

[11] See DTI, *The Impact of Shareholders' Pre-Emption Rights on A Public Company's Ability to Raise New Capital* (3 Nov. 2004), DTI, www.dti.gov.uk/cld/current.htm; DTI, *Pre-Emption Rights: Final Report* (Feb. 2005), www.dti.gov.uk/cld/public.htm.

[12] The capital maintenance rules are relaxed for private companies: see 2006 Act, s. 656 (reduction of capital); s. 691 (financial assistance); see *infra*.

[13] It is interesting to note that when limited liability was introduced in 1855 it was initially proposed that limited liability companies should possess a nominal capital of £50,000, but this was rejected: see R.R. Formoy, *The Historical Foundations of Modern Company Law* (1923) at 117.

[14] This assumes that the company is solvent. Insolvency law is prescriptive as regards hierarchy of claims and asset distribution where a company is insolvent.

[15] This Act has 1300 sections and 16 Schedules. There is also subordinate legislation.

The topic of capital maintenance under English law embraces what are standard issues in this area: (i) initial capitalization, (ii) payment for shares, (iii) the acquisition of shares using the company's capital, (iv) reductions of capital and (v) share buy backs. It is proposed to deal with these issues seriatim.

It must be emphasized, at the very outset, that the provisions in the recent Companies Act 2006 (hereafter 'the 2006 Act') dealing with capital maintenance do not fully reflect the preferences of the UK Government. Given the *ex ante* control imposed by this regime and its very prescriptive nature, which as seen does not follow the general approach of UK company law to possible abuses of the corporate form, this might not come as a complete surprise. Reform in this area was in fact constrained by the Second Company Law Directive of 1976 (hereafter 'the SCL Directive') which prescribes a set of minimum requirements Member States must adopt in their national legislation. The UK Government's hands were not, however, completely tied. The Directive only applies to public companies, meaning there was no restriction on the Government's ability to amend the law for private companies; furthermore, it could also remove elements in the previous Act, namely the Companies Act 1985 (hereafter 'the 1985 Act'), which went beyond the requirements of the SCL Directive.

Due to this limited room for legislative manoeuvre, one cannot view the provisions in the 2006 Act in isolation. When considering these provisions we shall thus also look at the extensive consultation that preceded the adoption of the 2006 Act as well as the SCL Directive and the recent work carried out on and around it. The aim, in each instance, will be to present the options that were available to the UK Government and the rationale behind the choices that were made. This exercise should also give us an indication as to what the law might have been if the Government had a completely free hand.

Before dealing with these provisions, we shall set the scene by briefly outlining the processes that led to the production of the 2006 Act and by providing an update on the state of play on the SCL Directive.

## II. Reform processes in the UK and the EU

The Company Law Review that led to the 2006 Act was kick-started in 1998 with the publication of the consultation paper *Modern Company*

*Law for a Competitive Economy.*[16] An independent Steering Group composed of company law experts was given the lead, and its remit was to carry out a thorough and wide-ranging review of core company law. The Steering Group consulted widely and produced a number of consultation documents and reports over a three-year period culminating in the production of its *Final Report* in 2001.[17] The Government's response was contained in a White Paper published in 2002,[18] which was followed by more consultation and the publication of another White Paper in 2005.[19] Following quite an eventful parliamentary process that saw a considerable number of last minute amendments, the new Companies Act was finally enacted in 2006 after no less than eight years of consultation and delay.[20]

It is worth highlighting at this juncture one of the main guiding principles followed by the CLRSG in its review, as this will inform much of what will follow. Rather than adopting prescriptive rules that hinder transactions, the CLRSG preferred granting more freedom and allowing market and other forces, buttressed by transparency requirements, to induce regulation through contract or other means. The CLRSG acknowledged, however, that this presumption against prescription could only be a starting point which would have to yield in circumstances where market and other forces coupled with transparency requirements would not work. Even then, prescriptive intervention must be justified in terms of the costs, benefits and effectiveness. The capital maintenance regime was thus examined under this light, and the proposals made, which we shall examine further on, were thus fashioned by this principle.[21]

As noted, the reform of the capital maintenance regime within the more general company law review process took place in the shadow of the SCL Directive. Under this directive Member States are required to put in place for public companies a regime which regulates the raising of capital, and, once raised, precludes its return to shareholders unless

[16] DTI, *Modern Company Law for a Competitive Economy*, (London, March 1998).

[17] DTI, *Final Report*, (London, 2001, URN01/942).

[18] White Paper, *Modern Company Law*, (London, July 2002, Cm. 5533), (hereafter 'White Paper 2002').

[19] White Paper, *Company Law Reform*, (London, March 2005, Cm. 6456), (hereafter 'White Paper 2005').

[20] For a succinct account of this process see G. Morse (gen. ed.), *Palmer's Company Law: Annotated Guide to Companies Act 2006*, (London: Thompson, Sweet & Maxwell, 2007), 49–51.

[21] DTI, *The Strategic Framework*, (London: February 1999, URN 99/654), paras. 2.21–2.23; DTI, *Final Report*, (note 17, above), paras. 1.10–1.11.

specified procedures are followed. This regime, which is meant to protect the interests of creditors, thus links the possibility of a return of value to shareholders to the amount of capital they contributed. In principle, and subject to exceptions, since the capital they contributed is meant to act as a cushion to safeguard creditors' interests, value can only be returned to shareholders to the extent that the company's net assets exceed its capital.

Efforts to amend the SCL Directive were running parallel to the Company Law Review in the UK, however their result ultimately proved to be fairly modest. The first proposals to simplify the directive were made by the SLIM Group in 1999.[22] SLIM was followed by the consultation and work carried out by the High Level Group of Company Law Experts, (hereafter 'Winter Group'), appointed by the European Commission in 2001 to make recommendations on a modern regulatory framework in the EU for company law. In their 2002 report they concluded that reform of the SCL Directive should, as a matter of priority, be carried out along the lines suggested by the SLIM Group with the modifications and supplementary measures suggested by them. They also recommended the undertaking of a feasibility study of an alternative regime that could be offered as an alternative to Member States.[23] The Commission followed these recommendations as it indicated it would in its May 2003 Action Plan for Company Law and Corporate Governance.[24] It thus issued a 'moderately deregulatory'[25] proposal to amend the Directive in October 2004 and finally amended it in September 2006.[26] These amendments did not generate much excitement in the UK. After consultation led by the Department for Business Enterprise and Regulatory Reform (hereafter 'BERR' – formerly the 'Department of Trade and Industry'

[22] Company Law SLIM Working Group, *The Simplification of the First and Second Company Law Directives*, Brussells, October 1999, (hereafter 'SLIM Report').

[23] High Level Group of Company Law Experts, *Report on a Modern Regulatory Framework for Company Law in Europe*, Brussels, 4 November 2002, (hereafter 'Winter Report'), 16, 81 and 88.

[24] As signalled in European Commission, *Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, COM (2003) 284 final, Brussels 21 May 2003, 17–18. Most of the EU documentation on this matter can be found at http://ec.europa.eu/internal_market/company/index_en.htm

[25] European Commission, *Proposal for a Directive amending Council Directive 77/91/EEC, as regards the formation of public limited liability companies and the maintenance and alteration of their capital*, COM (2004) 730 final, Brussels, 21 September 2004, 16.

[26] For a critical assessment of this proposal see E. Wymeersch, 'Reforming the Second Company Law Directive', Financial Law Institute Working Paper No. WP2006–15, November 2006.

(hereafter 'DTI')),[27] the Minister for Industry and the Regions declared that one change would be implemented and further consultation would be carried out on another.[28]

Also in line with the proposals of the Winter Group, the Commission engaged KPMG to produce a report on the feasibility of an alternative regime and the impacts of IFRS on profit distribution in October 2006. Prior to the production of this report however, the Commission adopted an updated simplification programme in a bid to reduce administrative burdens and boost Europe's economy. Company law was identified as one of the priority areas within this initiative and the Commission asked in this context, amongst other things, whether the SCL Directive should be partly or wholly repealed or simplified.[29] In December 2007 the Commission produced a synthesis of the reactions it received,[30] which revealed that whilst most respondents took the view that further action should not be taken prior to the completion of the report, a large majority of the respondents who expressed a view on the matter opposed repealing the SCL Directive.[31]

The KPMG report was finally published in January 2008. This report, *inter alia*, compared administrative burdens under the current regime with those under different regimes extant in other jurisdictions or proposed in the literature. One conclusion reached is that the compliance costs of the different regimes, including therefore the regimes based on the SCL Directive, is generally not overly burdensome and so reduction of these costs is unlikely to be a motivation for the transition to an alternative regime. Even if one accepts these findings as robust and significant, it must be emphasized that the focus here appears to be firmly on administrative costs and not on other important considerations which could justify repealing the SCL Directive (such as allowing enhanced

[27] DTI, Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company: A consultation document, (March 2005). DTI, Implementation of Companies Act 2006: A Consultative Document, (February 2007). Most of the UK documentation on this matter can be found at www.berr.gov.uk/bbf/index.html

[28] *Written statement – Companies Act 2006: Government response to consultation*, 6 June 2007. This is available on the BERR website.

[29] European Commission, Communication from the Commission on a simplified business environment for companies in the areas of company law, accounting and auditing, COM (2007) 394 final, Brussels, 10 July 2007, 5–6.

[30] European Commission, Synthesis of the reactions received to the commission communication on a simplified business environment for companies in the areas of company law, accounting and auditing, COM (2007) 394, Brussels, December 2007.

[31] Ibid., p.5.

flexibility and removing regulation that has a redundant purpose or a purpose that is achieved more efficiently by other means). The report also examined the impacts of IFRS on profit distribution and explained the effects of the introduction of a new regime.

On the basis of this report, the Directorate General Internal Market and Services concluded, rather disappointingly, that:

> the current capital maintenance regime under the Second Company Law Directive does not seem to cause significant operational problems for companies. Therefore no follow-up measures or changes to the Second Company Law Directive are foreseen in the immediate future.[32]

The momentum for substantially altering or even repealing the SCL Directive thus seems to have been brought to a grinding halt by this report of massive proportion yet narrow conclusions.

The latest developments at an EU level will be met with dismay by many[33] in the UK where a general sense of hostility towards the capital maintenance regime seems to prevail. The dismissive views of many prominent academics are well documented,[34] as are those of the influential Rickford Group.[35] Indeed out of the four regimes proposed in the literature and discussed in the KPMG report,[36] that proposed by the Rickford Group represented the most radical departure from the current regime. More importantly, the UK Government has been clear in its

[32] DG Internal Market and Services, Results of the external study on the feasibility of an alternative to the Capital Maintenance Regime of the Second Company Law Directive and the impact of the adoption of IFRS on profit distribution, Brussels, January/February 2008, 2.

[33] Clearly not by all – see the response of the Association of British Insurers, and to a lesser extent, the Confederation of British Industry to the *Communication from the Commission on a simplified business environment for companies in the areas of company law, accounting and auditing*, http://ec.europa.eu/internal_market/company/simplification/index_en.htm

[34] J. Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?', 63 *Modern Law Review* (2000), 355; J. Armour 'Legal Capital: An Outdated Concept?', *European Business Organisation Law Review*, 7 (2006), 5; E. Ferran, 'The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union', *European Company and Financial Law Review*, 3 (2006), 178.

[35] This group was established on the joint initiative of the Accounting Standards Board and the Company Law Centre at the British Institute of International and Comparative Law. The group produced a report that considers and makes recommendations about reform of the law and practice relating to company capital maintenance regimes. J. Rickford (ed.), 'Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance', *European Business Law Review*, 15 (2004), (hereafter 'Rickford Report').

[36] See also the FEE's informative discussion paper: FEE, *FEE Discussion Paper on Alternatives to Capital Maintenance Regimes*, September 2007, at www.fee.be.

view that the SCL Directive should be repealed.[37] In a recent publication the BERR in fact explains that 'the existence of outdated and ineffective provision in the Directive significantly constrained the scope for simplifying the capital maintenance and distributions provisions now contained in the 2006 Act'.[38] As will become clearer in the following section, this does not mean that the UK would have completely dismantled the capital maintenance regime if it were not for the Directive. Further relaxations would undoubtedly have been made but these might not have been as extensive as some, especially those viewing the UK debates from the Continent, seem to believe.[39]

## III. Initial capitalization

As stated earlier, English company law places no significant barriers to obtaining corporate form. The statistics on initial capitalization of companies in Tables 1–3 graphically illustrate this.[40]

These figures will not, of course, reflect the true 'economic' capital of a company, as opposed to its legal capital, as capital in the form of debt, particularly in the form of bank loans supported by directors' guarantees, plays a major role in the corporate financing of small and medium-sized companies.

As a requirement for registration of a company, the application must in 'the case of a company that is to have a share capital, a statement of capital and initial shareholdings'.[41] The statement of capital must state, *inter alia*, the total number of shares which are to be taken by the subscribers to the company's memorandum[42] and the aggregate value of those shares.[43] This gives a snapshot of the company's capital and the point of registration and it is intended to implement

[37] BERR, European Commission consultation on the simplification of EU company law and accounting and audit regulation: Note and Request for Views by the Department for Business, Enterprise and Regulatory Reform. August 2007.

[38] *Ibid*. para. 16. See also *White Paper 2005*, (note 19, above), 42–3.

[39] Ferran notes, for example, that some Continental commentators have tended to erroneously assume that the UK Government is in favour of radical deregulation on distributions. E. Ferran, Book Review of *Legal Capital in Europe* edited by Martin Lutter, *Journal of Corporate Law Studies*, 7 (2007), 357.

[40] DTI, *Companies 2004–2005* (note 3, above), Tables A2, B1 and B2.

[41] CA 2006, s. 9(4)(b).

[42] A company can be formed by one person subscribing to its memorandum: CA 2006, s. 7.

[43] CA 2006, s. 10(2).

Table 1. *Analysis of companies on the register at 31 March 2005 by issued share capital (from Table A7 in DTI, Companies 2004–2005)*

| Issued share capital | England & Wales No. of companies 000s | England & Wales Issued capital £m | Scotland No. of companies 000s | Scotland Issued capital £m | Great Britain No. of companies 000s | Great Britain Issued capital £m |
|---|---|---|---|---|---|---|
| No issued share capital | 82.0 | 0.0 | 4.9 | 0.0 | 86.9 | 0.0 |
| Up to £100 | 1,509.5 | 48.8 | 80.1 | 2.4 | 1,589.7 | 51.2 |
| £100 to £1,000 | 87.2 | 29.0 | 3.9 | 1.3 | 91.1 | 30.3 |
| £1,000 to £5,000 | 150.2 | 204.2 | 7.7 | 11.3 | 157.9 | 215.4 |
| £5,000 to £10,000 | 25.2 | 157.8 | 2.1 | 13.2 | 27.3 | 171.1 |
| £10,000 to £20,000 | 39.7 | 462.7 | 3.8 | 44.6 | 43.5 | 507.3 |
| £20,000 to £50,000 | 32.9 | 965.3 | 3.7 | 108.9 | 36.6 | 1,074.1 |
| £50,000 to £100,000 | 30.2 | 1,862.0 | 2.7 | 172.9 | 32.9 | 2,035.0 |
| £100,000 to £200,000 | 24.3 | 3,016.0 | 2.4 | 296.3 | 26.6 | 3,312.3 |
| £200,000 to £500,000 | 20.2 | 6,049.7 | 1.7 | 516.1 | 21.9 | 6,565.8 |
| £500,000 to £1m | 11.1 | 7,332.9 | 0.9 | 605.5 | 12.0 | 7,938.4 |
| £1m + | 31.8 | 1,697,378.0 | 1.8 | 79,847.8 | 33.6 | 1,777,225.8 |
| Total | 2,044.4 | 1,717,506.5 | 115.7 | 81,620.3 | 2,160.0 | 1,799,126.9 |

Table 2. *New incorporations of companies with share capital: analysed by amount of nominal capital, 2000–1 to 2004–5 (from Table B1 in DTI,* Companies 2004–2005*)*

| Nominal share capital | 2000–1 | 2001–2 | 2002–3 | 2003–4 | 2004–5 |
|---|---|---|---|---|---|
| England and Wales | | | | | |
| Up to £100 | 61.4 | 57.0 | 89.8 | 135.5 | 112.8 |
| £100 to £1,000 | 1.2 | 1.2 | 2.2 | 2.4 | 3.0 |
| £1,000 to £5,000 | 122.7 | 117.0 | 166.6 | 180.8 | 154.1 |
| £5,000 to £10,000 | 0.9 | 0.8 | 1.2 | 1.2 | 1.7 |
| £10,000 to £20,000 | 12.8 | 12.2 | 17.1 | 17.7 | 14.2 |
| £20,000 to £50,000 | 1.1 | 0.9 | 1.5 | 1.8 | 1.6 |
| £50,000 to £100,000 | 2.9 | 2.3 | 2.8 | 2.9 | 2.4 |
| £100,000 to £200,000 | 10.2 | 10.0 | 13.0 | 13.2 | 10.6 |
| £200,000 to £500,000 | 1.2 | 0.9 | 1.4 | 1.3 | 1.0 |
| £500,000 to £1m | 1.1 | 1.0 | 1.4 | 1.3 | 1.2 |
| £1m + | 5.7 | 4.6 | 5.6 | 5.8 | 6.4 |
| Companies with share capital | 221.2 | 207.9 | 302.6 | 363.9 | 309.0 |
| Companies without share capital | 5.0 | 5.3 | 6.2 | 7.5 | 8.4 |

Table 3. *Analysis of companies incorporated in 2004–5 by issued share capital (from Table B2 in DTI,* Companies *2004–2005)*

| | England & Wales | | Scotland | | Great Britain | |
|---|---|---|---|---|---|---|
| Issued share capital | No. of companies 000s | Issued capital £m | No. of companies 000s | Issued capital £m | No. of companies 000s | Issued capital £m |
| No issued share capital | 22.2 | 0.0 | 0.6 | 0.0 | 22.7 | 0.0 |
| Up to £100 | 265.0 | 5.7 | 14.6 | 0.3 | 279.6 | 6.0 |
| Over £100 & under £1,000 | 8.4 | 2.5 | 0.4 | 0.1 | 8.8 | 2.7 |
| £1,000 & under £5,000 | 16.5 | 17.9 | 0.7 | 0.7 | 17.2 | 18.7 |
| £5,000 & under £10,000 | 0.6 | 3.4 | 0.0 | 0.2 | 0.6 | 3.6 |
| £10,000 & under £20,000 | 1.3 | 14.4 | 0.1 | 0.6 | 1.4 | 15.0 |
| £20,000 & under £50,000 | 0.6 | 16.7 | 0.1 | 1.6 | 0.6 | 18.3 |
| £50,000 & £100,000 | 0.8 | 47.7 | * | 1.8 | 0.8 | 48.9 |
| £100,000 & over | 1.9 | 29,532.6 | 0.1 | 123.6 | 2.0 | 29,656.2 |
| Total | 317.3 | 29,640.4 | 16.5 | 128.9 | 333.7 | 29,769.3 |

* Fewer than 50 companies

Article 2 of the SCL Directive.[44] A public company must possess the minimum capital of £50,000 or the Euro equivalent;[45] this is needed to comply with Article 6 of the SCL Directive. What is interesting is the figure has not been altered since the Directive was introduced in 1991. Given the figure was settled over a quarter of a century ago, it is clear is that neither the EU nor the UK makes any serious attempt to ensure that when a company starts life it possesses any significant shareholder capital.

The CLRSG had noted that it was obliged to retain this requirement by the SCL Directive but initially asked whether the amount should be increased, reduced or retained.[46] After consultation, it proposed to retain the same amount subject to the power to vary it. The Winter Group noted that the only function this requirement has is to prevent the light-hearted setting up of public companies, but concluded that since there is no evidence that this constitutes much of a hurdle to business activity it would be wise not to spend too much time considering it. It thus proposed not to alter it.[47] The Rickford Group rightly attacked this approach arguing that useless provisions are always worth repealing.[48]

Under the 1985 Act, public companies were not only subject to minimum capital requirements, they were also required to adopt a limitation on the number of shares they could issue. Indeed, both public and private companies were required to state their authorised share capital in the memorandum of association, and this acted as a ceiling on the number of shares they could issue. The CLRSG proposed abolishing this requirement,[49] and this was taken up by the Government in the White Paper 2005 which noted that this amount is usually set at a higher level than the company will ever need and thus serves no useful purpose. The White Paper also pointed out that companies would still be able to include such a ceiling in their constitutions if it was so desired.[50]

[44] 77/91/EC.

[45] CA 2006, ss. 761–7.

[46] DTI, *Company Formation and Capital Maintenance* (London, October 1999, URN 99/1145), para. 3.17.

[47] *Winter Report*, (note 23, above), 82.

[48] *Rickford Report*, (note 35, above), 13.

[49] DTI, *Completing the Structure* (London, November 2000, URN 00/1335) para. 7.6 and DTI, *Final Report*, (note 17, above), para. 10.6.

[50] *White Paper 2005*, (note 19, above), 43.

## IV. Payment for shares

### *A. Par value – no discount rule*

Under the 1985 Act both private and public companies were required to have a fixed par (or 'nominal') value for their shares. Shares could not be issued at a discount to their par, and if they were issued at a price higher than their par, the difference between the two, known as the share premium had to be placed in a share premium account that would be treated for most purposes in the same way as share capital.

These measures are retained in Chapter 17 of the 2006 Act. Section 580 thus prohibits a company from allotting its shares at a discount, a prohibition that was considered to be part of the common law.[51] In *Ooregum Gold Mining Co Ltd* v. *Roper*[52] a company had gone into liquidation but application was stayed because fresh capital was to be introduced into the company. Subscribers were found for 120,000 £1 preference shares. The shares were allotted for 5 shillings (25p in today's currency) with the remaining 15 shillings (75p in today's currency) being treated as having been paid up. The company proved successful and a holder of ordinary shares brought an action broadly to have the allotment declared invalid and that the holders of the preferred shares should be obliged to pay the 15 shillings that had been credited on the preference shares. The action was successful. This, of course, was greatly to the benefit of the ordinary shareholders.[53] However, the price at which the shares were issued was the only realistic one attainable because of the precarious financial state of the company. The ordinary shareholders could have argued, but did not, that it was against their interests in that the dividend payable on the preference shares would be related to the nominal value of the share and not the amount paid up on the preference share;[54] this, however, is an issue relating to dividend policy and not capital maintenance. The reasoning of the court was that the relevant legislation[55] required a company to state in its memorandum 'the amount of capital with which the company proposes to be registered divided into shares of a certain *fixed*

[51] *Walworth* v. *Roper* [1892] AC 125 at 145. The courts also held that a company could not purchase its own shares: *Trevor* v. *Whitworth* (1887) 12 App Cas 409.

[52] [1892] AC 125.

[53] There was evidence to suggest that the money was to be used to pay off a debenture.

[54] This was undoubtedly the reason why the shares were issued as £1 shares and not as shares with a nominal value of 5 shillings. Modern drafting of the dividend rights of preference shares normally relates the dividend payable to the amount paid up on the shares. However, partly paid shares of any class are very uncommon in the UK.

[55] Companies Act 1862, s.7 (italics added).

amount' and this entailed that the 'fixed amount' had to be fully paid. The case thus turned on a tightly technical analysis of the relevant statutory language. There was no analysis of the principle. However, the court clearly appreciated that the rule would make it difficult for a company to raise capital where its shares are trading at a discount. More importantly, the court did not address the point that where shares are issued at a discount this cannot ever cause prejudice to creditors as in the event of a company's insolvency shareholders come last so that creditors will inevitably benefit from any shareholder contribution.[56]

This point was noted, however, by the CLRSG in the recent review. The CLRSG also noted that par values rapidly cease to have any significance (as the true economic value of the shares can rise or fall) and merely tended to confuse the layman. It viewed par value requirements as an anachronism and favoured their abolition for both public and private companies,[57] thus allowing companies to issue no par value (NPV) shares, the value of which would simply correspond to a fraction of the economic value of the company as a whole. If such shares were allowed, the no discount rule would obviously also be discarded as would the concept of share premiums. Removing par values could be the first step in dismantling the capital maintenance regime, but, significantly, the CLRSG did not go so far. In fact, it favoured placing the funds subscribed for NPV shares, less the amounts paid out in expenses and commission on the issue of those shares, into an undistributable reserve account.

The CLRSG recognized that the SCL Directive, which indirectly requires shares of public companies to have par or fractional values ('accountable par'), stood in the way of the adoption of this proposal for public companies. It thus proposed the abolition of par value requirements for private companies.[58] Many respondents were 'sympathetic' to this proposal but a large majority opposed it on the ground that it could not be extended to public companies. The CLRSG thus dropped the proposal whilst reiterating its preference for NPV shares[59] and recommending that the DTI (now the BERR) continues to pursue change

[56] Existing shareholders may be prejudiced by the potential dilution effect but this is not a concern of capital maintenance rules.

[57] DTI, *The Strategic Framework*, (note 21, above), para. 5.4.27. The possibility of abandoning the par value requirement was raised in the very first document produced in the UK review in 1998. DTI, *Modern Company Law*, (note 16, above), 7.

[58] DTI, *The Strategic Framework*, (note 21, above), paras. 5.4.26–5.4.32; DTI, *Company Formation and Capital Maintenance*, (note 46, above), para. 3.8.

[59] DTI, *Company Formation and Capital Maintenance*, (note 46, above), para. 7.3; DTI, *Final Report*, (note 17, above) , para. 10.7 and 338.

on this issues in the appropriate EU fora.[60] Both the SLIM Group[61] and the High Level Group[62] found NPV shares worthy of further investigation, indeed, the latter noted that wide demand for such shares was being expressed by the financial industry and the legal professions.[63] Unfortunately, however, this did not lead to any amendment of the SCL Directive in this respect.

### *B. Share premiums*

As seen, shares can be issued at price above par, i.e. at a premium; however, the no-discount rule does not require a company to allot its shares at a premium where they are trading in the market at a premium.[64] Directors who fail to obtain the maximum price from subscribers, namely a price that includes any available premium, may be in breach of duty and liable to pay the premium which could have been obtained as damages.[65] Obviously directors can forego a premium in the case of a rights offer, an employees' share scheme, or in offering share options to senior management. All these are seen as providing corporate benefit and can for this reason be defended as providing directors with the necessary flexibility to structure the company's capital. However, it is this very flexibility that the no-discount rule denies.

Curiously, the SCL Directive is silent as to how share premiums are to be treated if shares are issued at a premium. As a result, Member States that did not adopt the UK's logical but gold-plating approach of treating share premiums in almost the same manner as share capital have a much more flexible, if not fully coherent system in place.[66] The Rickford Group appeared to favour taking full advantage of this by allowing more freedom in the use of share premiums,[67] yet the CLRSG actually proposed tightening the regime to make it more coherent. In fact, it proposed removing the possibility available under the 1985 Act of using share premiums for the payment of the initial expenses of the company, commissions or discounts paid or allowed on the issue of other

[60] DTI, *Final Report*, (note 17, above), 340.
[61] *SLIM Report*, (note 22, above), 5–6.
[62] *Winter Report*, (note 23, above), 82–3.
[63] Ibid., 82.
[64] *Hilder* v. *Dexter* [1902] AC 474.
[65] *Lowry* v. *Consolidated African Selection Trust Ltd* [1940] AC 648 at 679.
[66] See the *Rickford Report*, (note 35, above), 20–3.
[67] Ibid., 21.

shares or debentures, or to the premium payable on the redemption of debentures,[68] and this was accepted by the Government in the White Paper 2005.[69]

### *C. Non-cash consideration*

One final aspect of the no-discount rule that is worthy of mention relates to the issue of shares for a non-cash consideration, for example, goods or services.[70] Under the common law, this was allowed provided there is no bad faith[71] or the directors failed to place any finite value on the non-cash consideration being exchanged for the shares.[72] As was stated in *Re Wragg Ltd*:[73]

> Provided a limited company does so honestly and not colourably, and provided that it has not been so imposed upon as to be entitled to be relieved from its bargain it appears to be settled . . . that agreements by limited companies to pay for property or services in paid-up shares are valid and binding on the companies and their creditors.

There remains the critical issue of how the non-cash consideration is to be valued. On this the courts deferred to the valuation by the parties:[74]

> The value paid to the company is measured by the price at which the company agrees to buy what it thinks it worth its while to acquire. Whilst the transaction is unimpeached, this is the only value to be considered.

Thus price is value. While it was understandable that courts would not wish to leave embroiled in assessing the commercial merits of a transaction, their severe hands-off approach undermined the no discount principle.[75] Directors are under a duty:

> to consider very carefully how few shares they can issue to achieve the desired acquisition of any particular asset, and, of course, for that purpose,

[68] DTI, *Company Formation and Capital Maintenance*, supra n. 46, para. 3.12. DTI, *Completing the Structure*, supra n. 49, 7.8.

[69] *White Paper 2005*, (note 19, above), 42.

[70] See CA 2006, s. 482.

[71] *Hong Kong and China Glass Co.* v. *Glen* [1914] 1 Ch 527; *Re White Star Line Ltd* [1938] 1 All ER 607.

[72] *Tintin Exploration Syndicate Ltd* v. *Sandys* (1947) 177 LT 412.

[73] [1897] 1 Ch 796, at 880.

[74] [1897] 1 Ch 796, at 831.

[75] Public companies must now have non-cash consideration valued by an independent valuer. CA 2006, Part 17, Chapter 6.

> to have a very firm idea of what are the respective values of the property being acquired and their own company's shares.[76]

However this does not have the same imperative effect as a capital maintenance rule.

The above still represents the law for private companies. Public companies, on the other hand, are subject to a much stricter regime. Article 7 of the SCL Directive prohibits shares to be issued for an undertaking to perform work or supply services, article 9 prohibits the issue of shares for an undertaking to be performed in more than five years time, and articles 10 and 27 require independent experts to value non-cash consideration received as payment for shares. The CLRSG did not devote much time to this issue. In one of its early consultation documents, it noted that the provisions dealing with these matters in the 1985 Act implemented the requirements of the SCL Directive, and it proposed some minor simplifications and modifications.[77] This issue was not pursued further in the later documents it produced. In contrast, there have been noticeable developments on the EU front. The SLIM Group argued that expert opinions 'were not always useful or necessary, and that the number of cases in which they are not required should be increased'.[78] They thus proposed eliminating this requirement when the consideration consisted of shares traded on a regulated market or a recent valuation was present. The High Level Group agreed, adding that these valuations are expensive and do not offer a total guarantee of the asset's real value.[79] They thus supported the SLIM Group's recommendations to eliminate this requirement in the above instances, adding that it should also be eliminated when the values could be derived from audited accounts.

The Commission followed these recommendations and thus the SCL Directive was amended by eliminating the need for an expert valuation in the above three instances. Minority shareholders are, however, given the right to require a valuation in these instances if

[76] *Shearer* v. *Bercain* [1980] 3 All ER 295, at 307.

[77] DTI, *Company Formation and Capital Maintenance, (note* 46, above), 25–26.

[78] *SLIM Report*, (note 22, above), 5.

[79] *Winter Report, (*note 23, above), 83. See also the criticism made by the Rickford Group, *Rickford Report*, (note 35, above), 16–18. The Winter Group also recommended that the Commission review the possibility of allowing, with appropriate safeguards, the provision of services as contribution in kind, which is banned by article 7 of the SCL Directive, as it might be particularly useful for start-ups and technological or professional companies and other companies in which specialized services are important assets.

certain conditions are met.[80] The UK Government welcomed these proposals, yet voiced concerns about the fact that some of the terms used in the proposed relaxations were not defined. It thus believed that there would be uncertainty as to whether the conditions for being exempt from valuation requirements were met, which, when coupled with the possibility that the minority shareholders could still require a valuation, would reduce the take-up of the relaxed provisions.[81] Thus there is no intention to introduce these relaxations in the UK.

## V. Financial assistance by company in acquisition of own shares

Since the Companies Act 1929, the companies legislation has prohibited the providing of financial assistance by a company in connection with the acquisition of its own shares or that of its parent company. The prohibition was enacted 'as a result of the previous common practice of purchasing shares of a company having a substantial cash balance or easily realizable assets and so arranging matters that the purchase money was lent by the company to the purchaser'.[82] The prohibition is designed to prevent the resources of a target company or its subsidiaries in a takeover are not 'used directly or indirectly to assist the purchaser financially to make the acquisition'.[83] Obviously, financial assistance could take the form of a gift[84] but normally in a commercial context it would be a breach of director's duties to make gifts. The prohibition is also directed against the entering into of imprudent transactions which could prejudice creditors and minority shareholders who were not participants in the transaction.[85]

The UK ban on financial assistance thus pre-dated the SCL Directive, which requires the imposition of a ban under article 23, but has since become one of the most controversial and criticized parts of UK com-

[80] See Directive 2006/68/EC Article 1 (2).

[81] DTI, *Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company: A consultation documen*t, London, March 2005. It would also not lead to a simplification of the law. DTI, *Implementation of Companies Act 2006 Consultative Document*, (London, February 2007), para. 6.23.

[82] *Chaston* v. *SWP Group plc* [2003] BCC 140, at 150 citing *Re VGM Holdings* [1942] Ch 235, at 239.

[83] *Chaston* v. *SWP Group plc* [2003] BCC 140, at 151.

[84] See CA 2006, s. 677(1)(a).

[85] See CA 2006, s. 677(1)(b)–(d) for other forms of financial assistance.

pany law.[86] The 1985 Act thus curtailed the strength of the ban for private companies by allowing them to provide financial assistance with respect to the acquisition of their shares but only on restricted conditions. In particular the directors of the company giving the financial assistance had to make a statutory declaration[87] broadly to the effect *inter alia* that the company would be able to pay its debts as they fell due during the year immediately following the provision of the financial assistance.[88] Also, in addition the auditors had to make a report that they were not aware of anything to indicate that the director's declaration of solvency was unreasonable.[89] The importance of the Companies Act 1985 provisions on financial assistance is that they embodied two techniques for protecting creditor interests: a solvency declaration of directors which places the responsibility on them for ensuring there is no creditor prejudice and external verification (the auditor's report) that the views of the directors were reasonable.

Despite the relaxation found in the 1985 Act, the provisions dealing with financial assistance were singled out right from the start of the UK review. Financial assistance was in fact targeted in the document that kick-started the review as being 'notoriously difficult'; it was also noted that 'legal and auditing fees are often incurred to ensure that innocent and worthwhile transactions do not breach these rules'.[90] This is not surprising given that the ban on financial assistance was criticized – to varying extents – in reports prepared by various committees in the UK going back to 1961.[91]

Initially, the CLRSG thought the complete removal of the ban for private companies too radical and thus proposed simplifying the whitewash procedure. It also proposed making some minor changes for public companies by, essentially, broadening the exceptions to the prohibition and creating new ones.[92] Emboldened by the responses it received, the

[86] See E. Ferran, 'Corporate Transactions And Financial Assistance: Shifting Policy Perceptions But Static Law', *Cambridge Law Journal,* 63 (2004), 225, and *Rickford Report*, (note 35, above), 25–7.

[87] CA 1985, s. 155(6).

[88] CA 1985, s. 156(2)(b). This declaration of solvency had to include contingent and prospective liabilities: s. 156(3).

[89] CA 1985, s. 156(4).

[90] DTI, *Modern Company Law*, (note 16, above), para. 3.3. See also DTI, *Developing the Framework,* (London, March 2000, URN 00/656), para. 7.19.

[91] Jenkins Committee. For a history of the ban see E. Ferran, 'Company Law and Corporate Finance' (Oxford University Press, 1999), 374–6.

[92] DTI, *Company Formation and Capital Maintenance*, (note 46, above), para. 3.42.

CLRSG eventually came down in favour of the complete removal of the ban for private companies,[93] whilst also retaining its proposal for minor changes for public companies.[94] In the White Paper 2005 the UK Government accepted the CLRSG's proposal to remove the ban for private companies, agreeing that abusive transactions could be controlled in other ways, e.g. directors' duties, wrongful trading and market abuse provisions.[95] It declined the proposals to carry out minor changes for public companies, saying that it would give priority to the CRLSG's overarching recommendation for fundamental reform through reform of the SCL Directive.[96] Section 678 of the 2006 Act thus continues the proscription of financial assistance but only with respect to a public company or the subsidiary of a public company providing such assistance. The two regulatory features for protecting creditor interests in private companies (a solvency declaration of directors and external verification) were both jettisoned in the 2006 Act.

Reform at the EU level has also been forthcoming. The SLIM Group proposed that the ban should be reduced to a practical minimum, suggesting that this could be done by either limiting financial assistance to the amount of the distributable net assets or by limiting the ban to assistance for the subscription of new shares.[97] The High Level Group favoured the former solution subject to the introduction of a number of safeguards.[98] The 2004 proposal thus allowed for financial assistance to be given up to its distributable reserves if considerably demanding conditions were met. Once again, the UK Government did not respond enthusiastically to this proposed amendment. It opined that due to the complexity and onerous nature of these conditions, it was unlikely that companies would utilize such a gateway procedure.[99] These conditions have been watered down in the actual amendment to the SCL Directive,[100]

[93] DTI, *Developing the Framework,* (note 90, above), para. 7.25; DTI, *Completing the Structure*, (note 49, above), paras. 2.14 and 7.12 and DTI, *Final Report*, (note 17, above), para. 10.6.

[94] DTI, *Completing the Structure*, (note 49, above), paras. 7.13–7.15; DTI, *Final Report*, (note 17, above), para. 10.6.

[95] *White Paper 2005*, (note 19, above), 41. See also DTI, *Developing the Framework,* (note 90, above), paras. 7.18–7.25.

[96] *White Paper 2005.* (note 19, above), 43.

[97] *SLIM Report*, (note 22, above), 7.

[98] *Winter Report*, (note 23, above), 85.

[99] See also E. Ferran, 'Simplification of European Company Law on Financial Assistance', *European Business Organization Law Review, 6* (2005), 93.

[100] Article 1 (6).

however, this has not been sufficient to move the UK Government to adopt this gateway procedure.

## VI. Reductions of capital

Under the 1985 Act companies, both private and public, could reduce their capital by means of a special resolution of shareholders and confirmation by court. Courts were thus entrusted with the role of protecting creditors. Creditors were given a right to object to a reduction even if it would not imperil their claim and they could block the reduction unless their debt or claim was discharged, determined or secured.[101] Courts, however, could dispense with this requirement, and in practice they generally did when reductions were structured to ensure that the creditors' interests would not be adversely affected by the reduction.[102] The CLRSG deemed this procedure inefficient since it could unjustifiably improve a creditor's position (e.g. by obtaining security). It was also known to be costly and time-consuming.[103]

The CLRSG thus proposed a simpler and more efficient approach, which would allow companies to reduce their capital by means of a special resolution of shareholders and a declaration of solvency by directors. Essentially, therefore, this proposal sought to replace an onerous creditor protection mechanism with a less onerous one. Once again the SCL Directive stood in the way of the adoption of this approach for public companies, yet this time only partially so. In fact, the UK had gold-plated the provisions on reductions of capital by requiring court approval for *every* reduction of capital. Under article 32 of the SCL Directive on the other hand, Member States are required to give creditors whose rights antedate the publication of the reduction a right to obtain security for their claims, but this can be set aside if the creditor has 'adequate safeguards' or the latter are not necessary in view of the assets of the company. It is only if a creditor is not satisfied with the above that he must he given a right to apply to a court.[104] Furthermore, under article 33, Member States are not required to apply these creditor protection mechanisms if the reduction is carried out to offset losses

[101] CA 85 ss. 136, 137.

[102] E. Ferran, '*Company Law and Corporate Finance*', (Oxford University Press, 1999), 368.

[103] DTI, *Modern Company Law*, (note 16, above), para. 3.2. *White Paper 2005*, (note 19, above), 41.

[104] There has been a recent change in Article 32 of the SCL Directive which shall be discussed further on.

incurred or create an undistributable reserve of not more than 10% of the reduced capital. The CLRSG thus proposed allowing reductions of capital for both private and public companies to take place by means of a special resolution and the production of a solvency statement, subject to the right of creditors of public companies to object. This right would not be available if the reduction was being made to write of losses or to create an undistributable reserve of not more than 10% of the reduced capital. In effect, therefore, the CLRSG was suggesting simplifying this procedure for public companies by dismantling the gold-plating.

At first it was proposed that this procedure would simply replace the old court approval procedure. Following the views expressed by most respondents to the consultation, however, the CLRSG proposed to retain the court approval procedure alongside the new procedure, as an option for companies.[105]

Government put forward the CLRSG's proposals in the White Paper 2002 but in the light of the mixed responses it received, it chose only to proceed with the proposals for private companies.[106] In its White Paper 2005 it explained that whilst many were in favour of simplifying the procedure for reductions, concern was expressed that due to the additional safeguards put in place for public companies few would actually make use of it.[107]

Under the 2006 Act, therefore, a private company may carry out a reduction of capital either by obtaining court approval or by the mere expediency of producing a directors' solvency statement. These two routes involve very different creditor protection mechanisms. In the latter case, the protection will be limited to a mere directors' solvency statement. Initially, it was suggested that solvency statements should here be supported by an auditors' report.[108] Auditors' reports increase time, costs and administration, but provide creditors with greater reassurance. They were required by section 156 of the 1985 Act in support of solvency statements made in connection with financial assistance provided by private companies, and are also required by section 714 of the 2006 Act in support of solvency statements made in connection with a purchase

[105] DTI, *Completing the Structure*, (note 49, above), para. 7.9; DTI, *Final Report*, (note 17, above), para. 10.5. For a list of reasons as to why a private company might want to use the court approval procedure see B. Hannigan and D. Prentice (eds.), *The Companies Act 2006 – A Commentary* (London: LexisNexis Butterworths, 2007), 175.

[106] The new procedure is found in ss. 642–646 of the 2006 Act.

[107] *White Paper 2005*, (note 19, above), 42.

[108] DTI, *Company Formation and Capital Maintenance*, (note 46, above), para. 3.30.

of own shares by a private company out of capital. Following its review of responses, the CLRSG came to doubt the need for this requirement and thus dispensed with it, proposing that reductions should take place under these less onerous conditions.[109] Furthermore, one notes that the 2006 Act requires companies to publicize purchases of own shares out of capital in the Gazzette and a national newspaper or by written notice to each creditor,[110] but no such requirement is imposed when carrying out a reduction.

One minor change has, however, taken place for public companies. The 1985 Act required authorization in the Articles for a reduction to take place both for private and public companies.[111] The CLRSG proposed abolishing this requirement given that shareholder approval was necessary and that companies could include additional restrictions in their constitutions.[112] Under s. 641 (1) of the 2006 Act, the position has thus been reversed as it simply allows companies to restrict or prohibit reductions by means of a provision in their articles. Further change is also in prospect following the amendment of the SCL Directive. In line with the suggestion of the High Level Group, the SCL Directive was amended to shift the burden of proof that the reduction will prejudice creditors onto creditors themselves.[113] As a result of this amendment, which is meant to avoid creditor hold-ups, the SCL Directive now requires Member States to give creditors the right to apply to court only if they can credibly demonstrate that due to the reduction their claim is at stake and no adequate safeguards have been obtained from the company. The UK Government welcomed this change,[114] yet at first considered its implementation unnecessary. It was noted, in fact, that companies that are concerned that a creditor cannot demonstrate that a reduction would affect the satisfaction of his claim, can ask the court to take this factor into account.[115] Presumably a court would then use its discretion and dispense with the requirement of obtaining the creditor's consent. In the response it received, however, many indicated that an amendment

[109] DTI, *Developing the Framework,* (note 90, above), para. 7.26; DTI, *Completing the Structure*, (note 49, above), para. 7.10.

[110] CA 2006, s. 719.

[111] CA 2006, s. 135.

[112] DTI, *Completing the Structure*, (note 49, above), para. 2.15.

[113] Article 1 (9).

[114] DTI, *Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company: A consultation document*, March 2005, London 40.

[115] *Implementation of Companies Act 2006 Consultative Document*, February 2007, London, para. 6.24.

should be made nonetheless for the purposes of clarity, and so the UK is now in the process of adopting this change.[116]

## VII. Repurchase of shares and redeemable shares

Under the 1985 Act public companies could purchase their own shares, whether redeemable or not, out of distributable profits or the proceeds of a fresh issue of shares, a system of capital substitution. Private companies could do so out of capital if a prescribed procedure, which included the production of a declaration of solvency, was followed. The CLRSG proposed to retain the substance of these rules subject to technical improvements and the following more significant changes.[117] Firstly, they proposed abolishing, for private companies, the requirement under the 1985 Act for authorization in the Articles to issue redeemable shares. Public companies alone would be subject to this requirement. Secondly, they proposed abolishing the requirement for authorization in the Articles for companies to purchase their own shares.[118] Thirdly, under the 1985 Act the terms and manner of redemption had to be included in the Articles, but the CLRGS proposed that these could be determined by the directors.[119] Finally, they proposed removing the special procedure for purchase of own shares out of capital for private companies given that a much simplified procedure for capital reduction was now being proposed.[120] The Government accepted all proposals save for the last,[121] which was dropped on the grounds that there could still be instances when this procedure would be available but the new reduction procedure would not.

## VIII. Conclusion

UK Company Law puts in place a number of mechanisms to protect against abuse of the corporate form. The capital maintenance regime, which is primarily meant to protect creditors, stands out as being the

[116] BERR, *Companies (Reduction of Capital Regulations) 2008*, Draft Regulations October 2007. These came into force on 06/04/08.

[117] DTI, *Completing the Structure*, (note 49, above), para. 7.16.

[118] DTI, *Completing the Structure*, (note 49, above), para. 2.15.

[119] DTI, *Completing the Structure*, (note 49, above), para. 7.17.

[120] DTI, *Completing the Structure*, (note 49, above), para. 7.18; DTI, *Company Formation and Capital Maintenance*, (note 46, above), para 3.62; DTI, *Final Report*, (note 17, above) para. 10.6.

[121] The rules on purchase of own shares out of capital are found in CA 2006 Part 18 Chapters 3–6.

one area in which substantial reliance is placed on *ex ante* quality control rules rather than *ex post* liability rules.

At least four types of mechanisms employed in the capital maintenance regime to protect creditors can be identified. The first is the imposition of mandatory rules, such as minimum capital requirements, the no discount rule, the prohibition of certain types of non-cash consideration and the ban on financial assistance. These rules should provide strong protection for creditors due to their mandatory nature; however, their lack of flexibility could, ultimately, have a deleterious effect on creditors. Moreover, as seen, such rules can also be hopelessly misguided, again doing more harm than good.

The second type of mechanism is that of court approval, such as that employed in reductions of capital. Such a mechanism should clearly provide comfort for creditors; however the time and expense entailed for the company might outweigh the benefits for the creditors. On the other hand, companies which obtain court approval then enjoy certainty and finality.

The third type of mechanism employed is that of solvency requirements and statements of solvency. Under the 1985 Act this was used, for private companies, in the context of financial assistance and acquisition of own shares out of capital. The 2006 Act has extended the use of this mechanism to reductions of capital by private companies. This type of mechanism is also found in other related areas of the law, such as in the voluntary winding up of companies.[122] As seen, this mechanism can be tweaked to be more or less onerous on companies, and hence more or less protective of creditors. Further protection can thus be provided by requiring an auditors' report in support of the statement of solvency and imposing publicity requirements. One must not forget that the *ex ante* control provided by statements of solvency are buttressed by rules that impose *ex post* civil and even criminal liability[123] in the event of default by directors in making such statements.

The final protective mechanism is that of directors' duties towards creditors. Directors in the UK do not have a duty to take the interests of creditors into account unless the company is insolvent or on the verge of insolvency,[124] however, certain duties that arise in the context of capital

[122] Section 89 Insolvency Act 1986.

[123] See CA 2006 ss. 643 and 715.

[124] *West Mercia Safetyweaer Ltd* v. *Dodd* [1988] B.C.L.C. 250 C.A. The exact position under the common law is somewhat controversial. See now also CA 2006 s. 172 (3).

maintenance might indirectly benefit creditors, such as those relating to the issuing of shares for a non-cash consideration.

As seen, the UK legislator's hands were tied when carrying out the changes now found in the 2006 Act. The consultation documents and the two White Papers reveal that there would have been further changes if the SCL Directive did not stand in the way. There would not have been a complete dismantling of the capital maintenance regime as some might think, but there certainly would have been further relaxations. The balance would probably have shifted towards *ex post* liability, coupled, in some instances, with some light *ex ante* control, particularly in the form of solvency statements. That appears to be the preferred way forward in the UK.