

Chapter 17

The Maintenance of Capital

Here, basic guidance to the end-of-chapter questions will be provided.

1. Define the following terms:

- **solvency statement;**
- **redeemable shares;**
- **treasury shares;**
- **dividend;**
- **interim dividend;**
- **final dividend;**
- **accumulated profits;**
- **realised profits.**

| Term | Definition |
|---------------------|---|
| solvency statement | A statement stating that each of the directors has formed the opinion that: <ul style="list-style-type: none"> • there is no ground on which the company could be found to be unable to pay its debts, and; • the company will be able to pay (or otherwise discharge) its debts as they fall due during the year immediately following the date of the statement |
| redeemable shares | Shares that offer their holder temporary membership, and can be bought back by the company, usually upon the company or holder's insistence |
| treasury shares | Shares held by the company 'in treasury', which can be sold, transferred or cancelled by the company |
| dividend | The distribution of all or part of a company's profits to its members, usually determined at x pence per share |
| interim dividend | A dividend paid out before the company's final accounts have been prepared (i.e. paid during a company's financial year) |
| final dividend | A dividend paid out once the final accounts have been prepared (i.e. paid following the end of the company's financial year) |
| accumulated profits | The amount of profit a company has made taking into account performance in previous years |
| realised profits | Profits are realised only when realised in the form of either cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty |

2. State whether each of the following statements is true or false and, if false, explain why:

- **the principal aim behind the capital maintenance rules is to protect creditors by preventing capital from being returned to the shareholders;**

- a company requires court approval in order to reduce its share capital;
- companies are generally prohibited from acquiring their own shares;
- companies are prohibited from providing financial assistance to others to acquire their shares;
- if a company has made a profit, then the company's members have the right to be paid a dividend;
- the CA 2006 provides that if the directors recommend an unlawful dividend, then they will be liable to repay the amount of that dividend to the company, irrespective of whether the recommendation was approved by the members.

- **The principal aim behind the capital maintenance rules is to protect creditors by preventing capital from being returned to the shareholders:** This statement is true.
- **A company requires court approval in order to reduce its share capital:** This statement is false. A private company can reduce its capital without obtaining court approval, by passing a special resolution that is supported by a solvency statement.
- **Companies are generally prohibited from acquiring their own shares:** This statement is true. Note, however, that there are exceptions (e.g. redeemable shares).
- **Companies are prohibited from providing financial assistance to others to acquire their shares:** This statement is false. Public companies are prohibited from providing financial assistance, but private companies are not.
- **If a company has made a profit, then the company's members have the right to be paid a dividend:** This statement is false. Generally, the members have no right to a dividend unless a dividend has been declared by the company.
- **The CA 2006 provides that if the directors recommend an unlawful dividend, then they will be liable to repay the amount of that dividend to the company, irrespective of whether the recommendation was approved by the members:** This statement is true.

3. 'The reforms to the capital maintenance rules introduced by the CA 2006 have improved matters little, and the rules are still excessively strict, complex and unnecessary.' Discuss this quote.

Introduction

- Every essay should begin with a succinct introduction that demonstrates that you understand the essay question. Briefly explain what the essay is about and set out what the essay will discuss and how it will be structured.
- This essay requires you to discuss the capital maintenance rules in the CA 2006 and the extent that they differ from the rules in the CA 1985.

The capital maintenance regime

- You may want to begin by giving a brief overview of the rules relating to capital maintenance, noting in particular the aims behind these rules, notably to protect the company's creditors by preventing capital from being returned to the shareholders.
- Before going on to discuss the 2006 reforms, it is also worth pointing out that the pre-2006 law was widely regarded as being overly technical and complex, anachronistic, and ineffective.
- There is little doubt that the 2006 Act has introduced a number of reforms that have improved the law in this area and you should discuss the benefits of these reforms. Beneficial reforms would include:
 - (a) The abolition of the concept of authorized share capital. As discussed at 16.2.3, the requirement was largely pointless and simply served to inconvenience companies.
 - (b) Allowing private companies to reduce share capital without the need to obtain court approval. Prior to the 2006 Act, in order to reduce capital, all companies needed to obtain court approval. Court approval was a major burden for private companies, especially given that, for many smaller companies, the capital maintenance rules are of little practical relevance.
 - (c) Abolishing the prohibition on providing financial assistance for the purchase of shares in relation to private companies. The prohibition served to prohibit transactions that were innocuous and commercially beneficial.
- Despite this, however, there are still problems that the 2006 Act has failed to remedy. Such problems would include:
 - (a) The 2006 Act has done little to prevent companies allotting shares at a discount. As noted at 16.5.2, the rules contained in the CA 1985 were somewhat lax in relation to private companies and the CA 2006 has done nothing to strengthen these rules.
 - (b) The minimum capital requirements imposed on public companies (discussed at 16.3) are universally regarded as weak and the 2006 Act has not strengthened them in any way.
 - (c) Although the prohibition on providing financial assistance has been abolished in relation to private companies, it remains for public companies. However, a convincing rationale for the prohibition has never been fully articulated by the courts and many believe that the prohibition should be abolished completely (although it is acknowledged that, currently, this is impossible as the prohibition is a requirement of the Second EC Company Law Directive).

Conclusion

- Every essay should end with a conclusion. Briefly summarise the main points/arguments and, if possible, come to a conclusion regarding the essay topic (i.e. which of the opposing views has the stronger arguments).

4. Dragon Goods Ltd ('DG') has issued 5,000 shares, all with a nominal value of £1 each. Stanley and Sophie (two of DG's three directors) each own 1,000 shares. Theo, a local businessman, owns 2,000 shares and the remaining 1,000 shares are owned by a number of local investors.

Since it was incorporated, DG has run at a loss and has never made a profit. Theo believes that this is due to the directors' poor management of the company. He also believes that, with new management, the company could be extremely profitable. He therefore starts buying from the local investors the shares that they hold in DG with a view to voting DG's directors out of office.

DG's directors discover Theo's plan. Accordingly, they cause DG to issue 3,000 new shares and offer to sell them to their friend, Gabrielle. However, Gabrielle cannot afford to buy these shares, but she does offer to sell her car to DG as part-payment for the shares. The car is only worth £1,500 but DG's directors accept the car as part-payment providing that Gabrielle uses the voting rights attached to her shares to defeat any resolution that aims to remove the directors from office. The remaining payment comes in the form of £500, which Gabrielle loans from DG.

Theo, realising that his scheme to oust the directors has failed, wishes to sell his shares, but he cannot find a buyer. Stanley tells Theo the DG will purchase the shares. By now, Theo has 2,500 shares and he agrees to sell them to DG. DG purchases the shares and they are duly cancelled. Having rid themselves of the troublesome Theo, the directors of DG recommend that a dividend be paid at a rate of 10 pence per share. Gabrielle agrees and between them, the dividend is declared and paid out.

Discuss the validity of the actions undertaken by DG and its directors.

Power to allot shares

- The first issue to discuss is whether the directors of DG have the power to issue shares on its behalf. The directors can only allot shares on the company's behalf if they have the power to do so.
- Section 550 of the CA 2006 provides that if a private company only has one class of share, then the directors are empowered to allot shares of that class. Accordingly, if DG only has one class of share and the 3,000 shares allotted were of the same class, then the directors were indeed empowered to allot the shares, subject to any limitations in the articles.
- If the 3,000 shares were of a different class or if DG has several classes of share, then s 551 provides that the directors will only have the power to allot the shares if they are authorized to do so by the articles or the members pass a resolution authorizing the allotment.
- We are not provided any information on DG's share structure, so note both outcomes above.
- If the directors have allotted the shares when not empowered to do so, they commit a criminal offence, although the allotment will remain valid.

Pre-emption rights

- The effect of allotting the shares to Gabrielle is that the holdings of the existing shareholders (notably Theo) are diluted. This makes it impossible for Theo to acquire the number of shares he needs to remove the directors.
- Section 561 of the CA 2006 provides the existing shareholders with a right of pre-emption, meaning that any new allotment of shares must be first offered to existing members in a way as to allow them to maintain their current holdings.
- By allotting the shares to Gabrielle, these pre-emption rights have been breached. Note, however, there are some instances where pre-emption rights will not apply, and one of these is where the shares are wholly or partly paid-up otherwise than in cash (s 565). As the shares were purchased using non-cash consideration (Gabrielle's car), pre-emption rights will not apply here.

Payment for shares

- Is it permissible for Gabrielle to pay for the shares using non-cash consideration? Section 582(1) provides that shares can be paid for in money or money's worth, meaning that non-cash consideration is acceptable.
- Here, however, the car is worth £1,500, but the nominal value of the shares allotted to Gabrielle is £3,000. Accordingly, the shares appear to have been allotted at a discount, which is prohibited by s 580 of the CA 2006.
- The consequence of allotting shares at a discount is that Gabrielle will be liable to pay an amount equal to the discount (i.e. £500). In addition, the company and every officer in default commits an offence.
- However, the problem is that the value of non-cash consideration is not as easy to determine as cash consideration. The company may value the car as being worth more than £1,500. Private companies are not required to have the non-cash consideration valued and the courts will usually only interfere if the consideration is clearly illusory. Here, that may not be the case.

Gabrielle's use of the shares

- The directors agree to accept Gabrielle's car as payment if she agrees to use the votes attached to her shares to defeat any resolution seeking the directors' removal.
- This appears to be a shareholders' agreement between the directors (as members) and Gabrielle. The terms of a shareholders' agreement bind those parties to it, so Gabrielle is bound to act in the way specified. If she does not, she can be sued by the other parties to the agreement, with remedies including damages, injunctions and specific performance.

DG's purchase of Theo's shares

- DG has purchased all 2,500 of Theo's shares. The issue that arises here is that it is a company is generally prohibited from purchasing its own shares (CA 2006, s 658). Breach of s 658 results in the purported acquisition being void, and the company and every officer in default will commit a criminal offence.
- There are several exceptions to this prohibition, but none seem to apply here.

Recommendation of a dividend

- The directors have recommended a dividend and, with Gabrielle's support, it has been declared. However, the fact that the company has never made a profit is an issue.
- Section 830(1) of the CA 2006 provides that a company can only make distribution out of profits available for the purpose. We are told that DG has no profits, and so the distribution is unlawful.
- If the members knew, or had reasonable grounds to believe, that the distribution was unlawful, then they are liable to repay the distribution. Stanley and Sophie (also being directors) should certainly have known.
- The directors are also jointly and severally liable to repay the amount of the dividend, even if it has been declared (*Flitcroft's Case*).