REFORMING CAPITAL

Report of the Interdisciplinary Group on Capital Maintenance

edited by

Jonathan Rickford*

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* Director, the Company Law Centre, British Institute of International and Comparative Law, April 2004.

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Executive Summary

This is the Report of an interdisciplinary group established in May 2003 to review company law on capital maintenance and developing accounting standards. European law prevented the UK Company Law Review (1998-2001) from fully examining the subject, but the European Commission's "Winter" Group recommended a full review in 2002 and current and expected developments in UK and International accounting standards made such a review urgent.

Chapter 1 sets out the background and basic theory of capital maintenance. Chapter 2 examines the present law, concluding that it is not widely relied on in practice by creditors, is complex, expensive and anomalous, producing inconsistent results as between companies within Member States and between different Member States within the EU. Rigid linkage of distribution limits to company balance sheets and profit and loss accounts produces distortions. These accounting statements provide an incomplete and unreliable basis for distribution decisions. The modern trend towards "fair value" (or more realistic) accounting principles produces more volatile "bottom line" outcomes which impede stable distribution policies.

Chapters 3 and 4 examine examples of the likely impact of current and proposed accounting standards on companies' capacity to provide shareholder returns on investment. Chapter 3, on employee stock options, concludes that the position under British and EU law will not be affected by proposed standards requiring expensing of options on grant, though there may be doubt and perhaps real difficulty in some Member States. But chapter 4, on pension funding, concludes that recognition of deficits will lead to very substantial reduction in funds available for distribution in all States – a major, often damaging, change, which requires a legislative response. Other accounting standards are expected to have similar results.

Chapter 5 proposes reform. The main focus should be on distribution rules which ensure continuing solvency. Distributions should comply with requirements for public certification of solvency by boards. A two part solvency test is proposed – ie that, having regard to the company's annual report and accounts, the company will in the directors' opinion immediately after any distribution (1) remain able to pay its debts and (2) have sufficient resources as a going concern to be able to meet its liabilities as they fall due for the following year. Where the latest audited balance sheet does not show a surplus sufficient to justify this view the directors should state that fact and explain why they nevertheless regard the distribution as within the test. Requirements to maintain additional capital reserves should be removed; in consequence the complex mandatory law on "par" values, capital raising and the quality of consideration for shares, and complex accounting rules on share premiums and buy-backs would be abolished, together with the "no issue at a discount" rule. But companies should remain free to adopt capital reserve requirements by contract or their articles, and as a transitional measure existing companies' existing capital reserves should remain until duly reduced. Member States should be free to retain the present law if they wish, but solvency certification should be required in all cases and there should be an EU-wide prohibition on "wrongful trading". Rules on

shareholder control and board authorization would not be affected.

If this proposal proves not to be negotiable at EU level, preventing its application to British public companies, it should still be adopted for private ones. Public companies should also be allowed the maximum freedom available within EU law, by removing requirements to capitalize share premiums and relaxing the constraint on capital reductions made to cover losses, subject to solvency certification for all distributions. These proposals would remove the current "gold-plated" implementation of the EU Directive in the UK replacing it with a proportionate and focussed regime.

This report was debated in draft at an international seminar of experts on 30 January 2004. It has now been finalized, published and transmitted to the British Government and the EU Commission.

Chapter 1: Background and Introduction

This Report is the work of an Interdisciplinary Group[1] of accountants, business representatives, economists, and lawyers, assisted by public servants who participated as observers but made a much valued and constructive contribution. The group was established on the joint initiative of the Accounting Standards Board (ASB) and the Company Law Centre at the British Institute of International and Comparative Law (BIICL). The work of the group was led and facilitated by the Company Law Centre's Director.

Nature of the Subject

The Report considers and makes recommendations about reform of the law and practice relating to company Capital Maintenance regimes. Such regimes are normally regarded as a technical matter for lawyers and accountants. They can however, and indeed are intended to, have very serious effects on company financing.

"Distributions"

Capital maintenance rules impose constraints on companies transferring their assets to company shareholders, in their capacity as members of the company with rights to enjoy the company's assets. Such returns of assets are widely known as "distributions". They typically take the form of dividends, but may also be brought about by purchase or redemption by the company of its own shares or by reconstructions of the company's capital (perhaps, but not necessarily, in the context of a merger)

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[1] The names of the members of the Group are at Annex A. At Annex B are the names of others who assisted or participated in its work. The ASB and the BIICL would like to express very sincere thanks to all those who participated in either capacity.

in conjunction with transfers of assets to shareholders. The need to conserve assets from distribution to shareholders leads to related disclosure policies and policies regulating capital increases and reductions (or write-downs) of capital reserves and the structure of authority within the company for making such decisions. All these policies serve the objectives of creditor protection and shareholder, or member, protection.

Creditor Protection

Such distributions reduce the capital available to satisfy the needs of creditors. Moreover, since they involve returns of assets to shareholders in priority to the interests of creditors, they have the potential to interfere with the normal system of priorities, which requires that creditors' claims on the company are satisfied in advance of those of shareholders.

Such distributions therefore raise significant creditor protection issues.

Capital increases may also raise creditor concerns if they are not made at a realistic value, to the extent that creditors *rely* upon the capital being maintained, and the published level of capital reflecting economic reality.[2]

Shareholder Protection

Moreover distributions may directly discriminate unfairly between shareholders, if one group of shareholders is preferred over another.

Similarly, capital increases, if they confer rights in exchange for contributions worth less (or conceivably more)[3] than their economic value on the new shareholders, may achieve an unfair reallocation of shareholders' rights over company assets (normally in the form of "dilution" of the existing shareholders rights, or "sharewatering").

Distributions and capital increases may therefore also raise shareholder protection issues.

However the real value of capital maintenance policies, either as a protection to creditors or to shareholders, is open to challenge. There is a growing literature and recent case law raising these questions[4] and some significant recent legislation abandoning some of the key principles[5] – the issues are considered in this Report.

2 The rules are designed to ensure that capital raised corresponds to the nominal amount claimed, but there is no assurance for creditors that it will not be (or, in the case of pre-existing capital, already have been) eroded by trading or changes in values – see ch 2.

3 Where it is more, it is the subscriber for the shares who suffers. The normal policy here is *caveat emptor*, but in the case of listed companies there is of course a wide range of regulatory provisions to protect the subscriber. We are not therefore concerned with investor protection in this sense.

4 Case C–212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459.

5 See the recent legislation in France reducing the minimum capital for the SARL (the French private company form) to 1 Euro, described in ch 2 and Annex C, below.

The Current Debate on Capital Maintenance

A number of factors make reform of capital maintenance a matter of current concern for practitioners and reformers: two reviews established by the European Commission, the Simpler Legislation for the Internal Market ("SLIM") review in 1999[6] and the High Level Group ("HLG", or "Winter", Group) Review in 2002,[7] have proposed significant reforms of the existing EU regime. This regime was established by the Second Company Law Directive on capital ("Second Directive") in 1976, with minor modifications in the Fourth Company Law Directive on accounts ("Fourth Directive").[8]

In 2001 the UK Company Law Review Steering Group proposed a series of detailed amendments of British law on the subject, while making it clear that if it had been open to them, without being constrained by European law, they would have proposed more radical change.[9] The Steering Group's proposals are currently being considered by the UK Government, with a view to legislation expected in 2005.[10]

The European Commission in its Action Plan[11] for modernizing company law and corporate governance has proposed, adopting the recommendations of the Winter Group, both detailed immediate work on the regime and a more fundamental reappraisal of the whole area in the medium term.

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[6] Report from the Commission to the European Parliament and the Council – Results of the fourth phase of SLIM, 04.02.2000, COM (2000) 56 final and SLIM Group's Final Proposals of 1999, COM XV/6037/99 (hereinafter "SLIM Proposals").

[7] Report of the High Level Group of Company Law Experts of 4 Nov 2002, <http://europa.eu.int/comm/internal_market/en/company/company/index.htm>. (hereinafter "Winter Report").

[8] Second Council Directive of 13 Dec 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second para of Art 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent 77/91/EEC [1977] OJ L26/1 (hereinafter: "Second Directive"); Fourth Council Directive of 25 July 1978 based on Art 54(3)(g) of the Treaty on annual accounts of certain types of companies 78/660/EEC [1978] OJ L221/11 (hereinafter: "Fourth Directive").

[9] The Company Law Review Steering Group, Modern Company Law For a Competitive Economy, Company Formation and Capital Maintenance, DTI 1999, URN99/1145 (hereinafter: "CLR, Company Formation and Capital Maintenance"); The Company Law Review Steering Group, Modern Company Law For a Competitive Economy, Final Report, DTI 2001, URN01/942 (hereinafter: "CLR, Final Report"). See for all review papers <www.dti.gov.uk/cld/review.htm>.

[10] White Paper, Modern Company Law, July 2002, Cm 5533, Ministerial statement to UK Parliament, July 2002, Hansard Col 61 WS (hereinafter: "White Paper").

[11] Communication from the Commission to the Council and the European Parliament – Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to move forward, 21 May 2003, COM (2003) 284 final., (hereinafter "Action Plan 2003"); see also Synthesis of the responses to the Communication of the Commission – A working document of DG Internal Market, 15 Nov 2003, <http://europa.eu.int/comm/internal_market/en/company/company/modern/governance-consult-responses_en.pdf>.

The European Council in its response to the Action Plan has emphasized the urgency of the need to modernize and simplify capital maintenance.[12]

All these factors led to the issue being on the Company Law Centre's original agenda. There are major general problems with European and UK law on any basis. However the commencement of this work as an urgent priority was provoked by the adoption of the new Community law accounting regime applying International Accounting Standards ("IAS"). It was recognized that this was likely to raise urgent issues relating to capital maintenance, which required early resolution, (ie effective within a matter of months), whether by analysis and clarification, or by changes to the law or practice.

In short, a combination of the present domestic and European law and new accounting standards threatens severely to curtail or prevent normal distribution policies by companies, raising the cost of capital and damaging their commercial prospects and the interests of employees, investors and other stakeholders.[13] This is because in 2002 the European Council and Parliament adopted a regulation rendering IAS, once they are approved by the Commission under the Regulation, directly effective in all member and European Economic Area States.[14] Domestic and European law requires distributions to be limited to amounts identified as available for distribution strictly by reference to companies' accounts. The new standards, once adopted in Member States, are likely to change these amounts, in some cases leading to very substantial reductions, without, in our view, sound economic justification in many such cases. The new standards, combined with the present law, will thus deprive investors of a return, and raise the cost of capital, without any underlying change in the economic position of the companies affected and in many cases without justification.

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[12] Council Meeting – Competitiveness – Internal market, Industry and research, 22 September 2003, <http://fire.pppl.gov/eu_iter_crm_092203.pdf>.

[13] The real importance of company distributions has been disputed, as being mere reallocations of value. But there is no doubt of the importance in practice of a ready means for economic value to be passed, in cash or kind, from the controlling hands of the board to the shareholders. The force of this is illustrated by the priority given by various governments in recent years to legislation to liberalise distributions by means of share buy-backs. Arguments are conveniently summarised in E Ferran *Company Law and Corporate Finance* (Oxford 1999) 408–412. See too M Miller *The Modigliani-Miller Propositions after 30 Years* [1988] 2 Journal of Economic Perspectives 99, D Soter and others 'The Dividend Cut Heard around the World', in J Stern and D Chow (eds) *The Revolution in Corporate Finance,* (Blackwell Oxford 2003).

[14] Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards [2002] OJ L 243/1. The automatic direct effect applies only to consolidated accounts of listed companies, but we expect most Member States to allow such direct effect to operate for individual accounts and for all companies, as the UK intends to do. Moreover in the UK the Accounting Standards Board will adopt standards based on the same principles for companies which do not adopt IAS. See the discussion in chs 3 and 4 below.

Purpose and Structure of this Report

The purpose of this report is accordingly to –

– examine the wider policy merits and defects of the present European regime, assessing these in a comparative context (chapter 2)
– analyse the problems to which the new IAS are likely to give rise, focusing on two main current problems; the report offers guidance where British law appears to allow the issues to be resolved in that way (chapter 3 (Share Options)), and proposals for reform where EU and British law do not (chapter 4 (Pension Deficits))[15]; and
– make proposals for wider reform (chapter 5).

Annex C to the Report contains a comparative analysis of capital maintenance and distribution regimes in the company laws of a number of representative modern economies. This is intended as a useful general source of information on the various approaches adopted in different jurisdictions and is relied upon at various stages in the Report. Annex D contains a selective bibliography.

Chapter 2: The Current Regime in General

Purpose of this Chapter

The main essentials of capital maintenance were adopted in the UK as a result of legislation and case law in the mid to late nineteenth century. Most EU Member States adopted similar principles in the same period. A moderately strict version was imposed on all Member States by the Second Directive on Company Law ("Second Directive")[16] in 1976.

In this chapter we examine the theory and practice of capital maintenance with a view to assessing the doctrine and its components. This will include a general examination of the core distribution rule, which links the amounts allowed to be paid in dividends to the company's accounting results. But the specific effects of this rule will be examined in greater detail in the context of stock-option costs and pension deficits in chapters 3 and 4. The analysis in chapters 2 to 4 will enable us to reach conclusions in chapter 5, taking account of the whole context, both on the best solution to the problems considered in the previous chapters and on what should be done by way of a wider reform. In the process we shall consider proposals made

[15] As is pointed out in ch 4, other IAS are likely to raise the same difficulties as those concerning share options and pension deficits. But a detailed examination of these lies beyond the scope of this report.

[16] Cited above.

in the past for more limited reforms,[17] which inevitably raise issues about the whole principle of the doctrine.

The accounting problems discussed in chapters 3 and 4 are new, but they illustrate the pre-existing issues of principle. A coherent overall response is required.

Comparative Approach

Comparisons with other systems (within the EU and beyond) are very important in carrying out this assessment.

The different approaches of European company laws are important for two reasons:

First, they illustrate ways in which UK law could be amended consistently with European law so as to alleviate the difficulties encountered in chapters 2 to 4 and to reduce the rigidity and cost of the doctrine as applied in the UK.

Second, such comparisons also raise the question of the value of the European harmonization, in the sense that they illustrate some differences in approach which produce radically different results for company creditors and members across Europe. Such divergence in national practice calls into question the value of harmonization, particularly since there appears to have been no experience of damaging effects of such divergence in the 25 years since adoption of the Second Directive.

But comparisons beyond Europe are also important. The policy objectives which capital maintenance is intended to address are universal. Any consideration of the merits of the EU approach and any reform proposals need therefore to consider the solutions adopted in non-EU systems. If such systems have developed solutions which are simpler and less restrictive for business, while providing (taking proper account of their contexts) sufficient protection for creditors and shareholders, and if they can be adopted without unacceptable and disproportionate transition costs, then there can be no objection to adopting them. It would evidently be foolish to fail to do so.

Plan of the Chapter

The approach taken in this chapter is as follows –

– in Part I the theory of capital maintenance is considered as a whole, briefly identifying its core principles, and examining the extent to which the general theory appears to be justified in practice.

The various components of the legal implementation of the theory and their merits and coherence are then considered –

[17] The main proposals have been made by the UK Company Law Review, the European SLIM and Winter Groups and the European Commission in its Action Plan, all referred to in ch 1.

- Part II deals with the rules on the publicity to be given to the amount of a company's capital with a view to ensuring that creditors are aware of the amount on which they can (in theory) rely;
- Part III covers the rules on the getting in, or raising, of capital (whether on first issue or subsequently) – ie securing that an appropriate minimum amount of capital is initially created and that the amounts received in consideration for capital issues truly correspond to the value of the issue – these rules are intended to protect creditors (who are believed to need to know that they can really rely on the amounts advertised) and shareholders (who need protection from dilution of their interests through shares being issued at disproportionate values);
- Part IV considers the rules restricting return of capital to shareholders through distributions and capital reductions:
  - prohibited distributions take place when the assets corresponding to the capital fund are returned to shareholders through dividends or repurchases of shares;
  - prohibited capital reductions take place when, through reduction of the amount denominating the fund itself (the capital "yardstick", or measure of the fund), assets are freed for distribution in accordance with the distribution rules without proper regard to the protection of creditors. Such a distribution may take place either immediately on the reduction, if surplus assets are thus then available, or subsequently, when a fresh distributable surplus, now defined by reference to the reduced amount of capital, has been accumulated.
- Part V considers certain ancillary rules which are, or are at least thought to be, related to, or consequent on, the application of the doctrine.

Part I: The Theory as a Whole and its Core Principles

The essential theory of capital maintenance is that the capital "subscribed"[18] by shareholders should be regarded as available for use in trading but should not, at least without special safeguards for creditors, be returned to the shareholders, except in a winding up after all creditors have been satisfied. Thus creditors may rely on this amount of assets being present to satisfy their claims, unless it has been reduced by trading. Even if it has been reduced in this way, they may rely on the amount of the original capital fund being replenished before assets may be returned to shareholders.

As the Second Directive puts it *"the capital…constitutes the creditors' security"*.[19]

[18] For the meaning of this term and whether it includes all the consideration received for the shares, including both nominal value and amounts in excess of that value ("premiums") see Part III below.

[19] Preamble, 4th "whereas".

"Nominal", "Par", "Accountable Par" and "No Par" Values

The theory of share capital as, in aggregate, an identifiable fund available for creditors in this way necessarily requires that there should be an identifiable amount at any time attributable to the shares. This is typically done by denominating each share as having an amount to be subscribed in respect of it, known as the "par" value. (If the company trades without making losses or profits, and no additional consideration (or premium) has been received for the share, the share's value will remain equal to this amount). Since this value is used as a basis for denominating the relative rights of shareholders, but does not correspond to the real economic value over time, it is also known as the "no mind value". At the time of adoption of the Second Directive Belgium had a system of "accountable par" values for shares. These perform the same function as par values except that the basis of denomination is by reference to the fraction of the aggregate of share capital contributed which they represent. Since then the introduction of the Euro, and the resulting need to translate the par values of shares in issue into the new currency while avoiding awkward fractions, have led a number of countries to adopt a similar approach. In some cases the shares have been called "no par value" shares. However these shares are still denominated by reference to a fraction of a capital fund the amount of which is fixed at any point in time.[20] They are not therefore "true" no par value shares, as known in much of the USA and some Commonwealth countries. Such true no par value (NPV) shares designate the value of shares purely by reference to the shareholder's proportionate share in the value of the enterprise, which will correspond to the value of its net assets and goodwill. Since this value will rise or fall continuously there is no identifiable amount which can be said to be providing a security or guarantee for creditors referable to a component in the value of the shares as stated on issue.

True NPV shares, which allow a much simpler regime and enable the values attached to shares to correspond to economic realities, are therefore inconsistent with the theory of capital maintenance and accordingly implicitly prohibited under European law. They are also inconsistent with many of the detailed rules adopted to implement the theory, as will become apparent below.

The case for NPV shares has been accepted in no less than four separate independent reviews of company law in the UK, stretching over the last 75 years.[21] The SLIM committee proposed in 1999 that the issue should be re-examined.[22] The Winter Group proposed that the issue should be examined as a matter of urgency as part of the immediate work to implement SLIM, recognizing the wide demand

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[20] Eg Germany, Arts 8, 23 AktG.

[21] It was first advocated by the Greene Committee in 1926, Cmd 2657, para 19; then recommended by the Gedge Committee, 1954 Cmd 9112; again by the Jenkins Committee 1961, Cmd 1749, paras 32-35; and again by the CLR, Modern Company Law for a Competitive Economy, Completing the Structure, November 2000, URN 00/1535, paras 7.2 and 7.3.

[22] See SLIM Proposals, op cit, Proposal 2.

being expressed for NPV shares.[23] A variety of approaches to the par value issue are adopted elsewhere in the world. In some legal systems the adoption of par values is optional and the implications are similar to those in Europe to the extent they are adopted. In other systems shares have no par value but the consideration received on issue (or capital raised) is transferred to an undistributable account, with consequences similar to those which apply to share capital in Europe, including the establishment of a reserve which is protected from distribution. In yet other systems all shares have no par value, and adoption of par values will have no effect (any autonomous contractual obligations apart), and there is no special reserve corresponding to share capital, but special prudential rules govern distributions (including share buy-backs). The value of these various approaches as models is considered in chapter 5.[24]

Minimum Amount of Capital

So far as public companies in Europe are concerned, the amount[25] of capital subscribed must as a matter of European law be at least a minimum of 25,000 Euros (about £17,000),[26] implemented into UK law at £50,000.[27] However only 25 per cent of the par value (see below) of a share needs to be paid up and this applies to the minimum capital; so the actual minimum to be paid up for public companies is 6,250 Euros.

Loss of Capital

Nothing precludes loss of share capital by trading. The Second Directive does provide that if more than 50 per cent of subscribed[28] capital is lost a general meeting

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23 Winter Report, op cit, 82.

24 See Annex C. In Canada, Dominion and some provinces' corporation laws provide that the whole of the consideration received for shares should be treated as "stated capital", which cannot normally be distributed. All shares are however true no par value shares. This thus divorces the fixed capital fund, which is maintained, from share denomination. There is therefore no rule against issues at a discount (see below). This provides a possible model for limited modification of the European regime – see below. In some US states (eg Delaware) either PV or NPV shares may be issued and in the case of NPV shares the corporation may decide what proportion, if any, of the consideration received should constitute stated capital, which cannot normally be distributed. Under the US Model Business Corporations Act there are no stated capital or par values and all shares are true NPV shares. This model was adopted with adaptations 10 years ago in New Zealand.

25 Ie the aggregate amount of the nominal (or "par") value of shares issued, or of their "accountable par", see above.

26 Art 6 Second Directive. Note that Art 6(3) Second Directive empowers the Council to increase the minimum, after quinquennial Commission reviews, which are to take account of an alleged trend of public companies becoming larger. This power has never been used after 25 years of inflation.

27 Sec 118 Companies Act 1985 (hereinafter: "CA 85"); see too secs 11, 43 (formation of a public company, re-registration of a private company as public).

28 Ie the aggregate nominal value or accountable par of the issued shares, see the discussion of the status of share premiums below.

must be called to consider the matter. Nothing is provided as to further consequences, though in some states the company is required to make good the capital lost or to reregister in a new form, where the minimum is not required.[29] No such provision is made in the UK, nor in Germany.[30]

Merits of the Theory

It is very questionable whether the theory achieves the stated objective of creditor protection in practice and this has been much questioned in recent academic literature.[31]

The theory does not provide a proportionate or adequate response to the problem it seeks to address.

The levels of minimum capital required, even though implemented at higher levels in some Member States, are trivial in comparison with the actual need for working capital of a public company. (Nor would it be possible to fix a set minimum amount which would be appropriate for all such companies).[32] The real effect is merely to attach a slight deterrent (easily evaded) to incorporation as a public company.[33]

The setting of the "reserve fund" at the amount of the aggregate nominal value of the shares actually issued is also arbitrary, given the varying needs of different kinds of company over time and the part (essentially accidental in prudential terms) which nominal values pay in company financing.[34] There is no reason why the aggregate amounts of nominal value raised over time (which are an accident of history) should constitute in any way an appropriate amount for a capital reserve.

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[29] Eg Italy. See Annex C. In Denmark action is required by private companies but not by public ones.

[30] Sec 142 CA 85, Art 92 AktG.

[31] See the Bibliography at Annex D.

[32] Special rules, which recognize that different consequences follow from different kinds of capital structure and availability of liquid funds, are in place and currently being amended for establishing appropriate margins of solvency for financial institutions, under the New Basel Capital Accord ("Basel II"), now expected in mid 2004, see Basel Committee on Banking Supervision Press Release, 11 Oct 2003 <http://www.bis.org/press/p031011.htm>; see Working Document of the Commission on Capital Requirements for Credit Institutions and Investment Firms, 18 Nov 2002 <http://europa.eu.int/comm/internal_market/regcapital/docs/dialogue/2002-workingdoc/200211-workingdoc-cover_en.pdf>; a new Commission proposal on such capital adequacy is expected in early 2004, see Commission Communication of 07 May 2003, Internal Market Strategy Priorities 2003-2006, COM(2003) 238 final, 12 <http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0238en01.pdf>.

[33] See, for example PL Davies *Gower and Davies' Principles of Modern Company Law* (Sweet & Maxwell London 2003) 230. The Winter Group took the view that the minimum capital requirement was without value but not worth the trouble of separate repeal. See Winter Report, op cit, 82. In our view useless provisions are always worth repealing.

[34] See the discussion of the capital status of share premium account and of the considerations which determine the split between premium and nominal value, below.

Moreover the amounts produced will vary arbitrarily as between companies with the same needs for such reserves.

Creditors require, as a matter of sound economic theory, a measure of security which is tailored to the commercial circumstances. In practice major creditors of public companies do contract for this and require no complex and expensive sets of default rules. Financing agreements normally contain their own specific and sophisticated provisions to ensure that measures can be taken well ahead of any insolvency to eliminate or manage creditors' risks. (Company suppliers also typically protect themselves by reservation of title clauses.) Evidence to the UK Review was to the effect that little, if any, importance was attached by such creditors to debtors' actual levels of share capital. For public companies in the modern economy there were far more sophisticated and effective means of protecting creditors. What mattered to them was the risk of insolvency and the quality and certainty of future cash flows.[35] For private companies, where levels of share capital were often very low, and proprietors often remunerated by salaries for employment rather than dividends, the doctrine was widely recognized as devoid of value.

There remains an issue in terms of the security of involuntary or casual creditors (for example tort victims injured by, and thus having a claim against, the company, or consumers). However their interests need to be considered against the fact that the most vulnerable are protected by compulsory third party insurance, and that the effect of the protections negotiated by contractual creditors is to provide, at least in the great majority of cases, a substantial free rider advantage.[36] Nor where involuntary debtors, such as tort-feasors, are not subject to the capital maintenance regime (eg because they are not public companies, or not incorporated at all) do such creditors (or victims) receive any special protection. Nor, by definition, do involuntary or casual creditors rely on the levels of capital maintained by the companies concerned.

The evidence to the Winter Group was to similar effect: while in theory capital maintenance protects creditors, there is widespread agreement amongst lawyers and financiers that in practice this is largely ineffective.[37] However, while accountants and bankers overwhelmingly regarded the doctrine as without justification in creditor protection terms, lawyers in some countries were reluctant to accept that the

[35] CLR, Company Formation and Capital Maintenance, op cit, para 7 and CLR, Final Report, op cit, ch 7.

[36] It is sometimes argued that major financial creditors are often fully secured, and thus insulated from the risks of small creditors, who gain no free rider advantage. This argument fails to take account of the risks and costs of exercising security rights and the fact that major creditors, even when secured, retain a continuing interest in solvency, which they in practice cover in contractual terms. Care also needs to be taken not to treat the "free rider" argument as proving too much. As will be clear from ch 5 below, we do not regard it as safe to rely on major creditors to contract to secure that all creditors are secured from insolvency. We merely point out that the effect of supervision by major creditors is to reduce the risks for all. The key arguments here relate to the rationality of the capital reserving rules, not possible alternative solvency requirements.

[37] See Winter Report, op cit, 78.

traditional justifications for the doctrine had yet been completely discredited.

Generally speaking, therefore, it is clear that capital maintenance is neither a proportionate nor a well-targeted regime for securing on going creditor-protection. There is also very considerable doubt whether the theory of capital maintenance serves its stated purpose and even greater doubt whether it does so effectively as compared with other possible approaches to creditor risk. However before firmly accepting this conclusion and assessing its implications, it is necessary to examine in detail the various components of the implementation of the theory, which may have merits and demerits of their own, and the interaction between them.

Part II: Publicity

To achieve the desired results in terms of creditor reliance (though the evidence indicates that such reliance does not operate widely in practice) it is essential that the amount of the capital fund is transparent to creditors. Thus European law requires that the nominal value and number of shares subscribed (updated at least annually) should be published in the company registry[38] and if references are made to capital in certain company correspondence this must be to subscribed and paid up capital.[39] Similarly the subscribed capital must be stated in the annual accounts.[40]

Part III: Getting in, or Raising, of Capital

To achieve the desired results in terms of creditor reliance on the capital fund it is also essential that assets got in for shares should represent the real value stated:

– shares must not be issued at a price less than their nominal value (a "discount"),
– non-cash consideration must be valued, and
– certain kinds of consideration are treated as unreliable and therefore ineligible in payment up of shares.

Issues at a Discount

The Second Directive requires that shares must not be issued at a discount to their nominal value, or accountable par.[41] While this is logically necessary to ensure that

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[38] Arts 2(c), 3(c) Second Directive; Art 2(1)(e) First Council Directive of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second para of Art 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community 68/151/EEC [1968] OJ L 65/8 (hereinafter: "First Directive").

[39] Art 4 First Directive, tailpiece, and Sec 351 CA 85. Subscribed capital does not include share premium account, although this may provide similar "security" for creditors – see below.

[40] Arts 9, 10 Fourth Directive, Sec 228 CA 85 and Schedule 4 (balance sheet formats).

[41] Art 8 Second Directive. See Sec 100 CA 85.

the share capital reserve is properly made up of assets at the outset, this position can, as we have seen, be reversed in trading at any time, and the provision has no other advantages, and a number of disadvantages:

– it prevents the issue of true NPV shares, even if combined with a "stated" capital fund which provides a reserve for creditors of the kind operated in Canada (which requires that all capital raised from share issues should be carried to an undistributable reserve), and in a less stringent form in a number of US States;[42]
– it prevents a company from issuing shares of a class already in issue where their value is less than the par value of the issued shares; the company must either engage in a reconstruction to reduce the par value of the existing shares (with or without a consolidation) or must create a new class; these routes impose additional expense and/or complexity and may attract unwelcome publicity. None of this is in the interests of creditors, for whom any increase of share capital, at any price, is an advantage, and whose interests are best served by the simplest and most efficient means of achieving this;
– while it is sometimes argued that the rule protects shareholders from dilution on an increase in capital, this will almost never be the case; the new shares are almost certain to be worth more or less than par value – in the former case a different and more severe rule is required to protect shareholders, in the latter the no-issue-at-a-discount rule provides excessive and uncommercial protection. For shareholders, like creditors, the possibility of a fresh issue of shares is an economic advantage, so long as the issue is at a fair price so far as they are concerned. To ensure such a price a different rule, or fiduciary standard, as already operates in the UK, is required, demanding such a price, and not the no-issue-at-a-discount rule.

Valuation of Contributions in Kind

The Second Directive requires valuation by independent experts of non-cash consideration for shares issued on formation and in subsequent capital increases.[43] The experts must have legal approval and must certify whether the value of the consideration amounts to the aggregate nominal value etc of the shares issued, together with the whole[44] of any premium. The Second Directive, remarkably, provides for

42 See above and Annex C below. Note, for example, that the Delaware surplus test requires the fund for distribution to be constituted from the excess of assets over the aggregate par value of any par value shares plus the amount of any stated capital adopted for no par value shares. It might be argued that the Directive only prohibits issues at a discount to par value if the shares have a par value. This seems far-fetched, given that this is a substantive and not merely a disclosure provision, and taking account of the overall framework, unsafe at least in the current climate of opinion.

43 Arts 10, 27 Second Directive; Secs 44, 103, 108–111 CA 85 make elaborate provision to implement these requirements

44 Presumably, creditors have no interest in the premium – see below – but shareholders need protection from dilution. The Directive requires the whole of the premium on a capital increase to be paid up,

no sanction or consequence if the report states that it does not reach this target, however, although the UK requirement is that the report must certify that it does.[45]

Such valuations are time-consuming and inconvenient in urgent cases, and expensive, particularly since they give rise to potential liabilities on the valuers, who are invariably insured (ultimately at the company's expense). They would thus represent a significant handicap for public companies using equity financing, but for the fact that they can be relatively easily avoided, see below.

The SLIM group proposed that these valuation requirements should be relaxed in cases where there are already recent equivalent valuations of the assets concerned or where the assets are securities traded on a regulated market (and thus with an established value). This proposal was endorsed by the Winter Group, which suggested that values derived from audited accounts should also be allowed. The group however also noted that such valuations were expensive and not entirely effective.[46] They may have had in mind that the requirement can relatively easily be evaded, by the company issuing the shares for a cash price and purchasing the relevant non-cash asset, either before or after the issue, at the same price. Moreover the requirement does not apply to an acquisition for shares of a non-cash asset consisting in the shares of another company, by takeover, or consisting in another company's undertaking, by merger.[47] This would appear to allow an issue for non-cash consideration to be achieved relatively easily, without any valuation, by incorporating a company to hold the assets in question and by then transferring the shares of that company by way of payment up of the issue, or by merging.[48]

Although British law has adopted the basic philosophy of capital maintenance since the mid nineteenth century, until the Second Directive there were no requirements for such valuations of contributions in kind, and there are still no equivalent provisions for private companies. So far as we are aware there has never been any pressure in the UK for the introduction of such valuation requirements.

The question arises why such transactions should be treated differently from any other purchase by the company at an under-value – ie not involving the issue of shares in consideration for the acquisition. The effect on shareholders and creditors is substantially the same.

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but there is no similar explicit requirement on first issue. British law applies the payment up requirement to all public company share issues – Sec 101(1) CA 85. Compare Annex C, Model 4 A, France, which does not require payment up in full for a first issue.

45 Art 10(2) Second Directive, with Sec 108(6)(d) CA 85.

46 SLIM Report, op cit, Proposal 1; Winter Report, op cit,, IV.3.c).

47 Art 27(3) Second Directive; see Sec 103(3) and (4) CA 85. The Directive requirement is for a "public" offer, but this apparently means no more than that it should be made to all the shareholders; there is no equivalent requirement for a merger.

48 The SLIM group noted that Member States took differing views about payment up of shares by the release of the company's indebtedness, or the conversion of debt into equity, and suggested that additional harmonization might be needed. This would appear to represent another loophole, but neither the Winter Group, nor the Commission in its response, proposed that it should be addressed.

In the UK, where the terms of share issues are normally determined by directors, discipline is provided in both types of case by the directors' fiduciary duties, which also apply in the takeover and merger cases where evasion of the Directive rules appears to be possible. These duties require the directors only to issue capital when this is in the best interests of the company (and therefore for consideration which is fair in the interests of the existing members), and thus indirectly its creditors. Information will also emerge from the accounts and the company's returns to the companies registry.

We are not aware (as a matter of the personal experience of the Group) of abuses of this kind having occurred in the UK, either for public companies before 1980, or for private companies before or since. Leaving aside reliance on the size of the capital fund (which seems to be very much a theoretical issue), creditors' interests are actually better served by an acquisition for shares, which postpones the interest of the transferors of the assets, than by a normal purchase, for which however no special protections are required. Shareholders, too, seem to be no more prejudiced in the share issue type of case than in the normal acquisition for value, but even if they were so,[49] this is a matter of internal governance which is recognized under the modern European approach as being a matter best dealt with by Member State law, or by the company's internal arrangements. The Winter group recognized that a general duty to issue shares only for a value which was fair to them would be a superior protection for shareholders against dilution than the current Second Directive provisions.[50]

So even if one accepts the basic philosophy of capital maintenance, which as we have seen is very questionable, there is considerable doubt whether the cost and complexity of such valuations is, having regard to their ineffectiveness in practice, justified. We do not believe that it is; shareholder remedies and proper disclosure should suffice, as they did without difficulty in the UK until 1980, and as they continue to do for UK private companies and for all companies in many other jurisdictions.

Ineligible Consideration for Shares

Shares may not under the Directive be paid up by the provision of an undertaking to provide services; nor may a long-term undertaking (other than for the payment

[49] It might be argued that the dilution is a permanent disadvantage, but so is the loss of assets involved in an under-value transaction. It might also be argued that share transactions may involve insiders and that special minority considerations arise. Non-share transactions seem to raise the same issues however.

[50] Winter Report, op cit, 88, 89. However care needs to be taken to avoid rigid rules elaborating the principle. What is fair value is a matter of business judgement. A deeply discounted rights issue on appropriate terms as to pre-emption may well be fair.

of cash) be accepted in payment up of shares.[51] Presumably the view taken was that such undertakings were too risky to be fit to pay up capital.

The Winter group thought the first of these rules unduly restrictive, particularly for start-up high technology companies, which often remunerate employees and professional advisers by the issue of shares, and that payment up of shares by undertakings to provide services should be allowed, with suitable safeguards.[52]

Here again the Directive seems to have an unduly restrictive effect, and neither of these rules applies to a British private company. There may be a case for such rules in the conditions operating in some European jurisdictions. However, again, we are not aware of practices contrary to either rule having caused problems in practice in the UK and we do not believe that the significant inhibitions to commercial freedom created by mandatory rules of this kind throughout Europe are justified.

Part IV: Returns of Capital to Shareholders and Reductions of the Capital Yardstick

The theory of capital maintenance clearly requires not only that the amount of the share capital should be properly paid in, but also that it (or strictly speaking a fund of an equivalent amount) should not be paid out again, except in the course of trading. It also requires that, if the capital fund is depleted by trading, no payments should be made, except in the course of trading, until sufficient assets have been recovered to replenish the capital fund once more.

Such prohibited payments can be brought about directly in two ways – either by dividends or by a purchase by the company of its own shares (which involves a return of assets to shareholders and potentially leads to the company holding an asset of no value as security for creditors in return, and moreover, if the shares are accordingly cancelled, to a reduction of the capital yardstick).

A similar effect can be achieved indirectly, by the company writing down its capital; this may either, if there are sufficient assets, lead to the immediate creation of a distributable surplus of assets over capital which could not otherwise have arisen, or, if there are insufficient assets to allow this at the time, to the creation through profitable trading of a distributable surplus subsequently, some or all of which would not have been available as such, had the capital not been reduced.

We now consider in turn the rules which deal with these problems.

[51] Ie executable in more than five years; Arts 7 and 9(2) Second Directive; Act of 1985, Secs 99(2), 102.

[52] Winter Report, op cit, 83.

Dividends

The rules on dividends are examined in detail in chapters 3 and 4. By way of summary, the Second Directive requires that dividends must be paid only when there is both

– a sufficient surplus of assets, net of liabilities, over share capital and undistributable reserves and
– sufficient accumulated profits, taken with available reserves,

to cover them.

The effect of both tests is to ensure that the whole of the par value received, and as interpreted in the UK and Germany the whole of all the value received for shares, is maintained as an undistributable reserve. The sense, or otherwise, of this has already been considered above. The first of these tests (the "net assets" test) is to be operated strictly by reference to the amounts shown in the company's accounts. It is less clear whether the second ("earned surplus" or "running profit and loss account") test is meant to operate in the same way. In the UK, logically, the same approach is taken to both.[53]

The strict linkage of the dividend test to the accounts produces a divorce between a company's real capacity to pay distributions and the result under the rules. This may produce either an unduly generous or an unduly restricted outcome. Where asset values are volatile over time and liabilities are to be met over time the accounts may produce deficiencies or surpluses which do not correspond to the real prospects of solvency. These problems, which are exacerbated by the adoption of the fair value approach in modern accounting practice, were, in general terms, also recognized by the Winter Group.[54]

But, even if, as we suggest in chapter 4, the calculation of the assets available for distribution were to be based on a more commercial and less mechanical assessment, the issue also arises of whether it is appropriate to adopt a balance sheet test which insists upon the maintenance of the capital fund in all circumstances.

We have already pointed out that the amount of the capital fund, which is a historic fact, bears no sensible connection with the company's financial needs on a going concern basis.

It should also be borne in mind that the freedom of Member States to determine what reserves are distributable can lead to huge divergences in the extent of protection provided. For example, in UK law share premiums are treated as substantially the same as share capital,[55] on the basis that the theory requires that all contributions

[53] Art 15(1) Second Directive. In the UK both tests are applied to public companies as required under the Second Directive, but only the earned surplus test is applied to private companies: see CA 85, Part VIII. But query whether the added application of the earned surplus test to public companies makes any difference in practice.

[54] Winter Report, op cit, 79 – "Capital protection based on such accounts is becoming a delusion".

[55] Sec 130 CA 85.

for shares should make up the fund and that the distinction between share capital proper (par values) and share premiums (the excess of the consideration received over par values) is essentially arbitrary. The opposite view (that share premiums should be regarded as surplus) has been authoritatively described as "ridiculous"[56] though it was British law until 1948. Yet the Directive does not, apparently, regard share premiums as part of subscribed capital and they are not therefore a component of the fund which is required to be preserved from distribution. In short they are an "available reserve". Some Member States take the same view.[57]

A Diversion – The Status of Share Premium Account under European Law

The issue of whether share premiums are required by European law to be treated as part of capital conveniently arises here, but it is of sufficient possible importance and general application to deserve separate and thorough treatment. If share premiums are lawfully distributable then that represents such a fundamental infringement of the argument that the consideration for shares represents some kind of security for creditors that it raises real questions as to the value of the whole concept.[58] Second, the fact that premiums are treated as part of capital in some Member States and not in others means that the harmonization of capital is a chimera in this very important respect. But third, in spite of the anomalous character of the point, if it is open to the UK to treat share premiums as free reserves then this may provide a significant means of alleviating some of the damaging results of the present regime without any need to amend the Directive.

It seems clear from textual analysis that European law does not generally require premiums to be treated as capital. The key provision on distributions requires only that "subscribed capital" is to be reserved from distribution under the net assets test and nothing prevents any other reserves being treated as "available" under the net earned surplus test.[59] It seems clear that share premium account is not part of "subscribed capital". The Fourth Directive treats it as a separate item in the bal-

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[56] PL Davies *Gower and Davies' Principles of Modern Company Law* (Sweet & Maxwell London 2003) 231.

[57] This is believed to be the view of the Commission and is apparently the law in Italy and Spain so long as the legal reserve (variously 10 per cent or 20 per cent of aggregate nominal value) is maintained. French law is less clear but there is no prohibition on the distribution of share premiums – see Annex C, Model 4.

[58] It needs to be recognized that, the trivial amount of minimum capital apart, the founders of a company are entirely free to set the amount of par value and the amount of share premium at any level they wish. The possibility of doing this is recognized in the Directive, which envisages shares being issued at a premium on the first issue – see Art 10(2) Second Directive (first issue for non-cash – valuation to cover sufficiency to match premium, if any). On increases of capital the natural growth of the company and inflation will lead to share premium account becoming a progressively larger share of reserves. Thus, of two companies making the same capital increase in equivalent circumstances, the longer established one will tend to raise more in premiums, and thus be encumbered by a smaller subscribed capital.

[59] Arts 15(1)(a) and (c) Second Directive, discussed extensively in chs 3 and 4, below.

ance sheet,[60] and the Second Directive makes different rules for payment up of "subscribed capital" on the one hand and "premiums" on the other.[61] Similarly the publicity requirements apply to subscribed capital, which is not taken to include share premium account (the approach also adopted in British law), presumably because share premiums are not part of the "security for creditors" under the Second Directive.[62]

This conclusion has, to British eyes, some quite remarkable results:

Some of the requirements on constitution of capital, ie that it is to be made up of assets capable of economic assessment and not to be made up of undertakings to provide services, apply only to the nominal value.[63] There is no requirement on first issue that the share premium be paid up.[64] The rules on reduction of capital and the protection of creditors in that context apply only to reduction of the subscribed capital and there is no equivalent provision for share premium account.[65] On redemption or withdrawal of shares the capital redemption reserve to be established is to cover the nominal value of the shares, but not any premiums.[66] British law does not permit share premium account to be reduced in such cases.

Other results, which are wholly consistent with this relaxed Second Directive view, are perhaps less surprising, because they moderate an unsatisfactory rule: The provision for steps to be taken on serious loss of subscribed capital refer to a reduction of assets to less than half of the subscribed capital – ie the aggregate nominal value and not any share premium account.[67] The no-issue-at-a-discount rule, as discussed above, applies to discounts on par value (which is arbitrary and dysfunctional), but not on premium (which would be a straitjacket).

On the other hand the Second Directive valuation rules for contributions in kind apply to assets contributed in respect both of nominal value ("subscribed capital"),

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[60] See Art 9 Fourth Directive, the balance sheet formats.

[61] Art 26 Second Directive.

[62] One provision points in the opposite direction – Art 39(g) Second Directive, evidently designed to permit redemption of redeemable preference shares under the then British regime, provides that a reserve corresponding to share premium account may be used for paying redemption premiums. Since the Art already allows sums available for distribution to be used for this purpose (para (d)), this might suggest that share premium account may not be treated as such a sum. However the effect of Art 15 Second Directive is to render share premium account not available for distribution if not so available under domestic law (as is the case in Britain); a special derogation was therefore needed here, at least to put the point beyond doubt. This is an example of the confusion created by a minimum standards directive unnecessarily giving explicit sanction to a higher Member State standard.

[63] Art 7 Second Directive. The CA 85, however, expressly applies both rules to share capital and to premium – Sec 99(1) and (2).

[64] Art 9 Second Directive, compare Art 26 Second Directive, requiring payment up in full on a capital increase, presumably to protect shareholders against the risk of dilution. British and German law (but not French) require payment in full in both cases – see Annex C.

[65] Art 32 Second Directive.

[66] Arts 36(1)(d), 37(2), 39(e) Second Directive.

[67] Art 17 Second Directive – British law takes the same view, Sec 142 CA 85, discussed above.

and of premium, both on first issue and on increases of capital.[68] This seems inconsistent with the overall theory, at least for first issues,[69] and a significant error, even in the Directive's own terms.

In sum, the Second Directive approach to the distinction between share capital and premiums produces results which are arbitrary and inconsistent, leading to the protections provided being disproportionate and/or trivial in many cases. Varying Member State implementation, applying scant regard to any coherent or rational philosophy, produces a level of harmonization which, if creditors did pay any attention to it as intended, (which we do not believe they do) would be substantially valueless.

Purchases and Redemptions of Own Shares ("Buy-backs")

The Second Directive generally requires that purchases and redemptions of own shares should be made out of distributable profits, with the creation of a matching reserve to cover the relevant share capital, but not, as we have noted, any share premium account.[70] In cases where a reduction of capital is permitted the Directive apparently requires compliance with the creditor protection measures which apply to such reductions.[71]

The Directive requires that any own shares repurchased should not exceed, in aggregate nominal value, when taken with the nominal value of shares already held, 10 per cent of the nominal value of the company's share capital.[72] This does not apply to redeemable shares.[73] This might be thought to mean that a repurchase may not in any event exceed 10 per cent of the outstanding capital, but that where the domestic law permits own shares to be held as assets the amount permitted is correspondingly reduced. However under English law the shares repurchased are normally cancelled; accordingly the fact that there have been previous repurchases does not inhibit subsequent ones. Perhaps more controversially, no provision has been made to limit the size of original purchases either.[74]

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68 Art 10(2) Second Directive, applied to increases by Art 27(2) Second Directive.

69 Arguably on a capital increase there is a need to protect shareholders from dilution, though the practical case for this is questioned above.

70 See above. However in the case of a simple purchase, rather than redemption or withdrawal, of shares the reserve is only required to be established if the shares are held as assets. The best explanation of this appears to be that the provision does not allow a reduction of share capital; the share capital will remain in place as a liability; an additional reserve will be needed if the shares repurchased are treated as assets: if shares are treated as assets then distributable profits must be correspondingly reduced.

71 Art 36(d) Second Directive.

72 Art 19 Second Directive.

73 Art 20 Second Directive.

74 The new British provisions allowing listed shares to be held in "treasury" (ie not cancelled on buy-back, but held available for re-issue) will however adopt the 10 per cent limit see Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003 (SI2003/1116) effective from 1 Dec 2003. It

The SLIM group proposed the relaxation of this 10 per cent rule, so long as the repurchase was made out of distributable profits. There is indeed no sensible reason as a matter of creditor protection why there should be any such arbitrary limitation. However the limit was first imposed as a crude means[75] of limiting abuse of the power given by the provision to enable companies to engage in possible market manipulation, and in particular the special exception enabling directors to do so without general meeting authority in order to avert "serious and imminent harm to the company" (ie typically, in some Member States, a takeover hostile to the directors). We understand that the provision was still regarded as useful to limit market abuse by those finalizing the Market Abuse Directive under the Financial Services Action Plan. The Winter Group accepted this point but believed that the rule, or any replacement of it, should be limited to listed companies, rather than all public companies as covered by the Second Directive.[76] We agree with this view, but also believe that rules on market manipulation and abuse are best dealt with by financial services regulation tailored for the purpose. Indeed in the UK the relevant provisions of the Financial Services and Markets Act provide comprehensive provision for the purpose.[77]

Reductions of Capital

If share capital is to operate as a security for creditors as intended, then, as discussed above, the fund should not be capable of reduction by the company without proper creditor protection. The Second Directive requires that creditors should, as a minimum, have "adequate safeguards" and the right to apply to the court for "satisfaction" at its discretion. British law currently normally requires creditor consent to such reductions,[78] unless the court is satisfied that alternative protections are in place (the invariable modern practice). The Company Law Review, which took a sceptical view of the value of capital maintenance, suggested creditors' protection should be limited to the minimum permissible under the Second Directive, and even less for private companies, to which the Directive does not apply, while requiring a board

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is not clear whether, if shares are held in treasury, this will reduce the number of shares available for buy-back in other ways. Apparently not.

75 At least in the eyes of the UK delegation – personal recollection of the editor. However if the 10 per cent constraint may legitimately be ignored, as has been done in the UK, if the shares are to be cancelled on repurchase there must be considerable doubt whether the intended constraint, or indeed any real limitation on market abuse, is effective.

76 Winter Report, op cit, 84–85.

77 Financial Services and Markets Act 2000, Part VIII. Important questions arise about the need for general meeting authorization for share repurchase and redemption transactions; these are dealt with, together with all such authorization matters, in Part V of this ch, below.

78 Sec 136(3)–(5) CA 85. "Creditor" means a person who would be entitled to prove in a winding up.

certification of solvency before reductions of capital could proceed.[79] The Winter Group was equally sceptical and suggested a solvency test for capital reductions involving distributions.[80]

However in the case where creditors are most exposed, ie where there are losses, the Directive allows capital to be written down without any provision for the protection of creditors.[81] The Winter Group noted that this was anomalous.[82] British law has not adopted this relaxation,[83] nor did the Company Law Review recommend that it should do so. Indeed it appears wholly inconsistent with the theory. In effect it removes the requirement that when assets have been eroded to a level below the capital yardstick they should be replenished before anything is returned to shareholders. The availability of this option, which is exploited in a number of Member States[84] again calls into question the value of the harmonization achieved and of the attempt to implement the theory at all.

If the capital reserve can be reduced when assets are lost, regardless of the interests of creditors, and there is no requirement to replenish it before distributions may take place, what real value does the so-called "security for creditors" which the Directive pretends to provide, really have?

Part V: Ancillary and Related Rules

The Second Directive contains certain rules which purport to be about capital maintenance and which are concerned with the quality of the company's assets, but are not about the preservation of the share capital fund. This is the area of financial assistance. The Directive also contains rules about capital formation, maintenance and reduction concerned with internal governance of these processes. These are frequently regarded as a critical part of the European regime, but are logically and as a matter of policy quite separate. This part of the chapter deals with these two residual areas in turn.

Financial Assistance

Article 23 of the Second Directive requires that a public company "may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its

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79 CLR, Company Formation and Capital Maintenance, op cit, paras 3.27–3.35; CLR, Completing the Structure, paras 7.9–7.10, CLR, Final Report, op cit, para 10.

80 Winter Report, op cit, 87.

81 Art 33 Second Directive.

82 Winter Report, op cit, 87.

83 However the provision requiring court protection is weaker, with the presumption against, see Secs 135(2)(b), 136(2) CA 85, tailpiece.

84 Eg Germany, France, Italy and Spain – see Annex C.

shares by a third party".[85] This article incorporates into the public company law of the European Member States the notorious "Financial Assistance" offence, first adopted in Britain in 1929. This was intended to put a stop to the practice, then thought to be "highly improper" and "open to the gravest abuse" as close to "a company trafficking in its own shares", of a "syndicate", or group of individuals, borrowing money to acquire a company's shares, becoming directors and lending the company's money to the group to pay off the first loan.[86]

In 1961 the British Review of company law (the Jenkins Committee) rejected this justification for the offence and recognized that, as then drawn, it criminalized many entirely innocent transactions.[87] The Committee were certainly correct in recognizing that the transactions outlawed involved no acquisition by the company of its shares (and hence no such "trafficking") and no necessary infringement of capital maintenance principles; a loan or guarantee, if negotiated on proper terms, would not affect the assets and, on whatever terms, was no more likely in itself than any other transaction to infringe the company's capital. The Committee however proposed that the offence should be maintained, on the ground that such transactions were likely to lead to the company's assets being lost because of the lack of credit-worthiness of the assisted parties, raising risks in particular for minority shareholders and creditors. They therefore suggested such transactions should be permitted if approved by special resolution (with a special minority objection) and made with a certificate of solvency.[88] These proposals were, unfortunately, not reflected in the Second Directive.

In 1981[89] British law was changed to create a number of exceptions to the offence for public companies, which were thought at the time to be consistent with the Directive, including dividends, purchases of own shares, and court approved reconstructions. This Act also created a "whitewash" procedure for private companies, allowing such assistance where approved along the lines of the Jenkins proposal.

In 1998 a major study[90] concluded that throughout Europe there were an absence of any clear understanding of the rationale for the offence and widely divergent approaches to implementation and enforcement. For example some countries adopted the view that even a lawful dividend made to assist a share purchase was unlawful.

In 1999 the SLIM committee proposed that the prohibition be "reduced to a prac-

[85] Exceptions are allowed for financial institutions in the normal course of business and employee share schemes, so long as the net assets are not reduced below the balance sheet test level; also for fixed capital investment companies – Art 23(2), (3) Second Directive.

[86] Report of the Company Law Amendment ("Greene") Committee, 1926 Cmd 2657, paras 30-31.

[87] For example restructuring transactions such as leveraged buy-outs or acquisitions of subsidiary companies on the basis that they will enter thereafter into an intra-group guarantee arrangement.

[88] Report of the Jenkins Committee, Cmd 1749, 1961, paras 170-187.

[89] Companies Act 1981, Secs 42-44, now Secs 151-158 of the 1985 Act.

[90] E Wymeersch 'Art 23 of the Second Company Law Directive' in J Basedow and others (eds) *Festschrift für Ulrich Drobnig* (Hamburg 1999).

tical minimum", perhaps by limiting the assistance to the distributable net assets, or by limiting the prohibition to newly issued shares. The Commission endorsed these suggestions without further comment in 2000.[91] It was not clear what was meant by "practical", nor, given that no rationale for the provision was offered, why the suggestions made were to be regarded as such. In particular it was unclear why new issues rather than subsequent purchases of company shares raised special problems, nor how the effect of a loan on distributable net assets was to be assessed.

In 2000, after extensive consultation, the British Review concluded that the costs of the provisions were disproportionate to any benefit and that the risks to which offensive financial assistance transactions gave rise were now well met by other better targeted legal provisions, including the remedies for wrongful trading, directors' fiduciary duties and improved derivative action remedies for them, rules on conflicted transactions by directors and their associates, and minority shareholder oppression remedies.[92] They noted that somewhat similar financial assistance prohibitions had existed in many US states but had been abolished, without adverse effects.[93] They therefore recommended, and the British Government has now accepted, that the prohibition should be completely abolished for private companies. They were of course unable to make such a recommendation for public companies, because of the Directive, and merely endorsed existing proposals to reduce the impact of the prohibition, mainly by refinement of the "purpose" component of the offence and by restricting the remedies. The prohibition thus remains for public companies a major and costly impediment to wholly legitimate and desirable commercial transactions, for example leveraged buy-outs.

In the case of public companies one useful effect of the prohibition is to prevent companies using their funds to "ramp" the market price, perhaps to advance or prevent a takeover bid.[94] We recognize the need to address this kind of activity, but believe it is best done by a targeted prohibition, addressing market manipulation in listed shares, as has been proposed for the 10 per cent limitation on own shares, above. Here again, for the UK, financial services legislation already provides the answer.

Capital Raising, Maintenance and Reduction – Internal Governance Aspects

The Second Directive requires authorization, either in the company's constitution or by the general meeting, of various capital transactions. Thus constitutional authority

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[91] Report from the Commission to the European Parliament and the Council – Results of the fourth phase of SLIM, 04.02.2000, COM (2000) 56 final.

[92] The Company Law Review Steering Group, Modern Company Law – For a Competitive Economy, Developing the Framework, March 2000, paras 7.16-7.27 (hereinafter: "CLR, Developing the Framework").

[93] The prohibition has been abolished for the Canada Business Corporation and in Ontario, but retained in New Zealand, in a much weakened form – see Annex C.

[94] As in the notorious Guinness case in the UK.

is required for the issue of compulsorily withdrawable[95] and of redeemable shares.[96] In the case of redeemable shares the constitution or instrument of incorporation must also set out the terms of redemption, but there is no requirement that this should precede their issue.[97] General meeting authorization is required for:

- purchases of own shares;[98]
- increases of capital;[99]
- any departure from the general rule that equity issues for cash must be subject to pre-emption (this requires a special resolution);[100]
- reductions of capital;[101]
- redemptions of capital without reduction;[102] and
- reductions of capital by compulsory withdrawal of shares.[103]

The SLIM group proposed that the requirement for a detailed report justifying an issue free of pre-emption for an ad hoc waiver by the general meeting under Article 29(4) should be removed for listed shares where the issue price was to be at or near the market price. Winter supported this view.[104] SLIM also proposed extension of the compulsory withdrawal provisions. This was however overtaken by the Winter Group's support for a compulsory buy-out right (with a corresponding minority sell out right) for 90 per cent – 95 per cent majorities (and corresponding 10 per cent – 5 per cent minorities).[105]

These provisions are logically separate from the main debate on capital maintenance as a mechanism for protecting creditors. This is important, as it is sometimes suggested that a critical approach to capital maintenance necessarily implies hostility to these provisions, which generally secure a close control over the board of directors in relation to capital transactions. That is not the case.

In fact, while many of these provisions might be regarded as matters for Member

[95] This must precede the issue of the relevant shares, Art 36 Second Directive.

[96] Art 39(a) Second Directive; alternatively in the instrument of incorporation.

[97] Art 39(c) Second Directive. The British Review took the view that this allowed the terms and conditions of a redemption to be set by amendment to the instrument of incorporation, by means of a return of allotments, see the discussion in CLR, Company Formation and Capital Maintenance, op cit, 163–165 and CLR, Final Report, op cit, para 7.17.

[98] Art 18 Second Directive (with exceptions in Arts 18 and 19),

[99] Art 25 Second Directive (with a possible 5 year general meeting mandate for the board).

[100] Art 29(4) Second Directive (specific decision to waive pre-emption – requires board report justifying issue price) and (5) (general authority for the board for up to five years).

[101] Art 30 Second Directive.

[102] Art 35 Second Directive (ordinary resolution if authorized by constitution, otherwise special majority).

[103] Art 37 Second Directive.

[104] See SLIM Proposals, op cit, Proposal 6; Winter Report, op cit 84.

[105] Winter Report, op cit, 84–85.

States or companies in the climate of modern European attitudes to company law and corporate governance, they appear to cause no problems in practice in the UK and appear to be in substance desirable and to accord with European principles of shareholder control.

We do not believe that any further change to these authorization and governance rules, other, possibly, than that proposed by the SLIM and Winter groups, is needed.

Summary

Our concern is therefore with the creditor protection aspects of capital maintenance. The doctrine sets out to provide "security" for creditors. There is very considerable doubt whether creditors rely on it significantly in practice. In some respects it actually prevents or impedes transactions which are in creditors' interests. In others it imposes unnecessary costs and restrictions on debtor companies. The theory is disproportionate in its effects, ill-targeted for its purpose, inconsistent in its own terms and has led to widely divergent and misleading measures of implementation. Some provisions are readily avoidable. Others simply represent loopholes or gaps in the scheme of protection. In short the regime is incomplete, dysfunctional, avoidable and unsuccessful as a harmonization measure.

The UK implementation is also stricter in some important respects than it needs to be. In view of the weakness of the arguments for the doctrine as a whole this additional "gold-plating" seems very difficult to justify.

The capital maintenance doctrine also gives rise to the specific, but very important, problems which are caused by the linkage of distributions to the accounts, explored further in chapters 3 and 4. This, we believe, requires urgent reform.

In short, there is very little, on balance, to be said in favour of the present regime. However there remains a problem of ensuring that assets of companies are not returned to shareholders, by direct or indirect means, in a way which gives rise to disproportionate risks to creditors. If there is no better answer to this problem, then current capital maintenance, with all its imperfections, might still arguably (perhaps with some incidental improvements on the lines of the SLIM proposals) be better than nothing. In chapter 5 we examine in the light of comparative study whether there is a better way of addressing this issue.

Chapter 3: Employee Stock[106] Options and Distributable Profits

Introduction

In recent years the practice has become more common of remunerating company employees, particularly directors and senior management, by the issue of options to subscribe at some future date for the company's shares. The main economic argument for this is that giving such employees a stake in the prospects of the business directly involves them in its success and encourages high performance; the so-called "agency problem" that company employees' interests diverge from those of shareholders is thus reduced or eliminated.[107] The main objections are that: such options encourage senior management to distort the company's performance, in substance and/or as represented in its accounts, ramping the share price, particularly over the short term while options are outstanding; that they distort distribution patterns;[108] and that they conceal the true cost to shareholders of the company's remuneration policy, destroying comparability of performance, both of the same company over time, and as between companies which adopt stock-option plans and those which do not.[109]

Accordingly, the Winter Group recommended, and the EU Commission and Council accepted in principle, that such plans should be subject to shareholder approval, for listed[110] companies,[111] and their costs should be recorded as costs of the company in the profit and loss account.[112] The International Accounting Standards Board (IASB) published such a standard in February 2004, coming into effect on 1 January 2005 and the UK Accounting Standards Board (ASB) has indicated that it will make a substantially identical standard.[113] This chapter is concerned

[106] In this report the words "stock" and "share" are used interchangeably to refer to the shareholder's or member's title to his rights as such in a company.

[107] Numerous provisions of UK and European law favour employee share schemes for similar reasons.

[108] For example, distributions through dividends will reduce the assets per share, thus reducing the share price; abandoning distributions (leaving shareholder to be remunerated by capital appreciation) or making them by share buy-backs will (if done at a fair price) leave the assets per share constant. Also buy-backs, by increasing demand and narrowing the market, may enhance the share price and thus increase the value of options.

[109] Similar difficulties arise where companies issue stock options in consideration for the acquisition of assets other than employee services. The principles set out in this chapter should apply in such cases also, but because of the special difficulties which result from the need immediately to write off the services received (see below) in the case of employee stock options and the effect of this on the profit for the year this chapter concentrates on such options.

[110] Apparently, but this is not explicit.

[111] Winter Report, op cit, 66, Action Plan 2003, op cit, 16. Already UK law for most cases under Financial Services Authority Listing Rules, Rule 13.13, May 2000.

[112] Winter Report, op cit, 66. See now Commission consultation, Fostering an appropriate regime for the remuneration of directors, MARKT/23.02.2004.

[113] IASB, IFRS 2, Share-based Payment, February 2004. For background see IASB Exposure Draft

with the effect of the adoption of such standards on company financing as a result of their interaction with EU and UK domestic law on capital maintenance and distributions.

The Legal Character of an Employee Stock Option

While stock option schemes vary widely, normally an employee stock option is a bundle of legal rights conferred upon an employee of a company limited by shares (often a senior management employee or director,[114] but some companies have all employee schemes) by the company in consideration for the provision, whether before or after the conferring of the option, of employment services. The employee is entitled during a period (the "exercise" period), beginning at a date after the grant of the option, the period being laid down in the terms of the grant, on payment of a price also determined at the time of grant (the "strike" price), to call for the issue to her or him by the company of a share in the company (or, sometimes, the transfer to her, by or on behalf of the company, of such a share acquired in the market).[115]

The strike price is normally set at the market price at the time of, or very shortly before, the grant of the option, but it may, at least in theory, be set above or below such a price. (Tax rules and corporate governance norms delimit both the delay before exercise and level of strike price, but these could change, and nothing turns for our purposes on their effect.)

If the share value exceeds the strike price (ie the option is "in the money") at a time when exercise is permitted, the employee may exercise the option, paying the strike price and claiming her share. (While she is free to exercise the option at a time when the strike price exceeds the market price she would of course not be rational to do so.) She may retain the share or sell it at once or subsequently, reaping a profit. (Very often she will at least sell sufficient shares to recover the cost of paying the strike price.) While the option is outstanding its value may fall or rise according to the extent to which it is in the money, but it can never have a negative value, because the employee is never obliged to exercise the option at a loss.

2, Share Based Payment, November 2002. ASB Press Notice PN232, 19 Feb 2004 <www.asb.org.uk> announcing FRS 20 Share-based Payment, which is to be the same as IFRS2, except that for unlisted companies it will come into effect from 1 Jan 2006, to allow such companies further time to prepare to adopt it. FRS 20 will not apply to "smaller entities" pending ASB's customary review of standards for such entities. For background see ASB Financial Reporting Exposure Draft 31, Share Based Payment, Nov 2002.

[114] Options are sometimes conferred on non-executive directors, who are not technically employees, for performance of their duties as officers of the company. While such options raise special difficulties for independence of directors the same considerations apply to them as to employee options for the purposes of this report.

[115] Sometimes the scheme requires the company to give the employee the cash value of the option. Such arrangements amount to payment in cash and present different problems. IASB ED2 proposes that adjustable provisions should be set up on grant for such payments, reducing distributable profits, but the effect is one of timing. The cash payment is already treated as an expense.

The essence of the bargain is that the company has agreed that the value of the option is crystallised on exercise, at the expense of the existing shareholders, by dilution of their rights at the time of exercise, in the following sense: The normal legal rule is that the directors of a company, who normally have power to issue the company's shares, may only[116] do so on terms which are in the best interests of the shareholders as a whole, ie normally at a value properly reflecting the rights in the company acquired by the new shareholder. This is because the issue of a share at less than such value will have the effect of "diluting" the rights of the existing shareholders, ie the new shareholder will have acquired a share in the value of the company at less than its proportionate value and the additional value is gained by her at the expense of existing shareholders. However in the case of a stock option the essence of the bargain is that the employee receives a prospect of obtaining value on exercise by precisely such dilution – ie by virtue of the fact that she pays less in the form of the strike price than the fair value of the shares at the time. There is nothing necessarily offensive, legally or economically, about this. The consideration for the benefit conferred on her has been provided by the employee in the form of the quality of the services (*ex hypothesi* contributing to profitable performance) for which the option was awarded.[117]

The Accounting Treatment of Employee Stock Options – Company Earnings

In the view of the IASB and ASB, the value conferred on employees as a result of the issue of stock options should be treated as an expense of the company in consideration for services received by the company.[118] That value is always positive (because of the one-way character of the rights conferred – there is never an obligation to exercise – see above); it should be calculated on grant on the basis that it represents the price, at the time of the commitment to confer the option, for the employee's services in question. These services are treated as consumed at once or (more normally) over time, according to the period of service in respect of which the option is conferred.[119] Their consumption is to be treated as an expense. A corresponding amount is to be credited to reserves, or equity (ie the shareholders' funds part of what is sometimes regarded from a legal perspective as the "liabilities side" of the balance sheet).[120]

The objective of this treatment is to ensure that the company's results, and in particular its earnings for the year, reflect the reality of its performance, that is to say that it has received employee services in exchange for the issue of value. There are also important comparability considerations; if the performance statement (or

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116 Absent a special authorization to do so on the part of shareholders.

117 The economic merit of employee stock options, and in particular whether they resolve or increase employee-shareholder agency problems, is controversial, but not the concern of this report.

118 See IASB ED 2, paras BC29-39, IFRS 2 IN5(a), 8, 9.

119 See IFRS 2, 14, 15. IASB ED2 para BC34, BC43, 44.

120 IFRS 2, 7.

profit and loss account) of a company which relies for remuneration of its employees on stock options, is compared with that of one which has a similar performance but relies on cash, then the former's results will, absent an appropriate record in the performance statement of the value received and given for the options, compare favourably, and unfairly, with those of the latter. There is thus a strong case, if the performance statement is to give a true and fair view of the result for the year for the benefit of shareholders and the markets as a whole, for an appropriate amount to be charged against the earnings for the year.

Nor should the treatment be adjusted or reversed if the option changes in value or lapses. The issue is the value of the consideration which has been given by the company for the services, not the effect on the value of that consideration of anything which happens subsequently.

It is not the purpose of this Report to question the merits of this rationale. The authority for determining what standards are required to be met in order to give a true and fair view is for the UK the Accounting Standards Board[121] and, for accounts for periods beginning on or after 2005 prepared in accordance with the EU Regulation, will be, both for the UK and the rest of the EU, the IASB, subject to adoption of its standards by the Commission.[122]

Legal Consequences (1) – Accounts

We now turn to the implications for accounting practice of the above approach and the legal implications for the preparation of accounts.

A company's individual (ie prepared for its business alone) profit and loss account is required under UK and European law to give a true and fair view of the profit or loss for the company for the year, and its balance sheet a true and fair view of its state of affairs, or financial position, at the end of the year.[123] The same requirements apply in respect of group accounts prepared on a consolidated basis for a group of companies.[124] The EU's regulation requiring use of EC adopted IAS does not affect the substance of this.[125] While the Regulation applies as a mandatory

[121] Sec 256 CA 85, Accounting Standards (Prescribed Body) Regulations 1990, SI1990/1667, and 2001, SI2001/1090.

[122] Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards [2002] OJ L 243/1 (hereinafter: "IAS Regulation"). On Commission adoption see below. Strictly speaking new IAS are to be known as International Reporting Standards ("IFRS"). For convenience they are referred to as IAS in this Report.

[123] Art 2(3) Fourth Directive; Sec 226(2) CA 85.

[124] Art 16(3) Seventh Directive; Sec 227 CA 85.

[125] The IAS Regulation supplements and does not repeal the existing directives, see preamble, (3). When adopting standards the Commission will ensure that they produce a true and fair view "considered in the light of" those directives "without implying a strict conformity with each and every provision". The legal effect appears to be that the Fourth and Seventh Directives remain in force but that where a standard is adopted this will be to secure the provision of a true and fair view in accordance with

matter only to the consolidated accounts of listed companies the DTI has announced that it proposes to take advantage of the Member State option in the Regulation to enable a large number of other companies to adopt IAS both for individual and consolidated accounts.[126] IAS will then be directly effective for such companies. In any event the ASB proposes a UK standard aligned with the IAS which will apply to all company accounts. The substance of the new standards will thus apply to all UK company accounts.[127]

The above standards will determine authoritatively what is required to give a true and fair view of the grant of stock options from the point of view of the profit and loss account.[128] However they provide incomplete guidance as to the balance sheet treatment in that they do not indicate a complete treatment for the necessary increase in shareholders' funds.

The effect of treating the cost of stock options to the company as an expense in the balance sheet will be to reduce the overall profit or increase the overall loss. Thus the amount of retained profits (or accumulated losses) within shareholders' funds (sometimes designated "Profit and Loss Account") will be reduced (or increased). However as noted above the amount of shareholders funds will also be increased by a corresponding amount (there is no corresponding reduction of net assets). What is the correct accounting treatment of this item?

Both as a matter of general analysis and in the terms of the items prescribed for disclosure in the accounting formats set out in the Fourth Directive and Schedule 4 of the Companies Act 1985 (which will continue to apply, except to the extent that IAS override them)[129] it is clear that, at least at any time after grant of the option

best international practice and the standard will override any requirement in the directives which is inconsistent with it. Since IAS are principles based and directors' judgement is mandated by IAS 1 the effect is a very substantial displacement of the Directives as they apply to form and content; see now European Commission, Comments concerning certain articles of Regulation 1606/2002, Brussels, Nov 2003, <http://europa.eu.int/comm/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf>.

[126] See DTI, International Accounting Standards, Aug 2002, URN 02/1158 (consultation) <http://www.dti.gov.uk/cld/ias_sbs.pdf> and Ministerial Statement, 17 July 2003, and now DTI and HM Treasury, Modernisation of the Accounting Directives and IAS Infrastructure, London, March 2004 <http://www.dti.gov.uk/cld/pdfs/ias_infastructure.pdf>. This treats IAS as displacing existing rules on form and content.

[127] Except smaller entities – see ASB PN 232 above.

[128] Sec 256 CA 85 and IAS Regulation.

[129] See above. However the substance of the argument here is not affected by this point. Note that IAS will apply under the proposed UK regime, where a company exercises the option to that effect, to an unlisted company's consolidated and to any company's individual accounts. Once a company exercises this option the new community law will apply to them, with any appropriate modification of the Directives. However companies which do not exercise this option will be subject to domestic law, which implements the Directives largely in their unmodified form, but will be subject to the equivalent ASB domestic standard. Directive 2003/58/EC of the European Parliament and of the Council of 15 July 2003 amending Council Directive 68/151/EEC, as regards disclosure requirements in respect of certain types of companies [2003] OJ L 221/13 ("hereinafter: "Modernization Directive") amends, in particular,

but before its exercise, the reserve cannot be share capital or share premium (no share has been issued) nor is it a revaluation reserve.

Nor is the item an amount anticipating the issue, and therefore to be regarded as in the nature, of share capital. If and when the share is ultimately issued it will be treated as paid up by the payment of the strike price, and this will be carried to share capital and share premium as appropriate. The share is not in fact paid up by the services provided in consideration for the benefit of the option,[130] but by payment of the strike price. Moreover such a treatment would not reflect the bargain with the employee, which is that on issue of the share she will get rights more than commensurate with the strike price, at the expense of the other shareholders, by dilution (see above).

Nor is the item a provision – such provisions are defined, in the Act and the Fourth Directive,[131] as being amounts intended to cover liabilities the nature of which is clearly defined and which are either likely to be incurred, or certain to be incurred, but uncertain either as to amount or the date on which they will arise. The company is not anticipating any liability or loss on the option's exercise.

In short, the only heading amongst those prescribed by law into which the new item could fall is "other reserves"; none of the other headings[132] is appropriate.

A further question arises as to the treatment of this reserve on exercise or lapse of the option. We have already established that on exercise the shares are issued paid up by the strike price, which is carried to share capital and share premium account, as appropriate. In the view of the standards authorities there is no case for reversing the expense of the option in the profit and loss account since the justification for retaining it remains (see above) and there is no case for recording an increase in earnings. On lapse there will be no movement on share capital and no consideration received by the company, but the profit and loss account treatment remains unaltered. The corresponding reserve should therefore also remain to the extent that it otherwise survives.[133]

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the Fourth and Seventh Directives in certain respects to achieve a "level playing field" for companies applying the directives with those applying IAS.

130 This might be contrary to the rule that shares are not to be paid up by future work. But it would anyway be impossible because the work and services are written off, either immediately or more probably over the option period, and will have been entirely written off on exercise of the option when the share is issued. See Art 7 Second Directive, Sec 99(2) CA 85.

131 CA 85, Schedule 4, para 89, as to be amended, see DTI and HM Treasury, Modernisation of the Accounting Directives, etc op cit, Annex D, Schedule 2, para 9, and Art 20(1) Fourth Directive, as amended by the Modernization Directive Art 1(7) and passim.

132 The remaining headings are effectively "Creditors" and "Accruals and Deferred Income" – see Arts 9, 10 Fourth Directive; CA 85 Schedule 4, balance sheet formats.

133 Though it may be appropriate to record a transfer from one kind of equity to another. See generally, IFRS2, Basis for Conclusions BC 218-221.

Legal Consequences (2) – Distributions

As noted in chapter 2, in order to protect creditors, and in some respects to protect shareholders also, traditional capital maintenance regimes impose restrictions on the extent to which assets may be returned to shareholders in their capacity as such by way of dividends, or, less typically, by purchases of own shares by the company, or by reductions of capital.

The EU, and of course in consequence the UK, adopt two requirements, both of which have to be satisfied in the case of public companies,[134] to achieve this.

The EU requirements are that distributions must satisfy both of two requirements; they –

(a) must not exceed the excess of net assets in the accounts over the amount of the aggregate of subscribed capital[135] and any reserves which are not distributable under the law[136] or the constitution of the company ("the balance sheet test"); *and*

(b) must not exceed the profits for the year, plus profits brought forward, plus any sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law and the constitution of the company[137] (the "net earned surplus test").

(While only (a) is expressly linked in the Second Directive to the accounts for the preceding year, it is arguable that a similar linkage is also intended to operate for (b). While the position is not certain, we believe that there is strong probability that the European Court of Justice, adopting a teleological approach, would so rule.)

This appears to mean that, so far as the Community requirement in (a) is concerned, the UK is free to treat the reserve arising on the grant of a share option as not an "undistributable" one: since it is not mentioned by the Directive as undistributable it is for law or practice in the Member State concerned to decide the question.

So far as (b) is concerned, similarly nothing apparently prevents a "withdrawal" from the same reserve for the purpose being treated as distributable, ie it may be so on the ground that the reserve is "available for this purpose". It can thus be reduced and the amount released added to the earned surplus, so long as there is no domestic

134 The EU law does not apply to private companies; UK law applies the second to them – see below.

135 In some Member States (eg UK, Ireland) subscribed capital is treated as including all consideration, or contributions, received for shares issued – ie share capital and share premium account – in others (eg Spain, Italy and apparently France) premiums are not included. In Germany share premiums may be credited to the legal reserve but are never distributable Arts 54(1), 57(1) AktG. See the discussion in ch 2 and Annex C.

136 This will include a reserve for net unrealized profits under Art 33(2) Fourth Directive. See also ch 5.

137 Art 15(1) (a) and (c) Second Directive, paraphrased.

law provision rendering the reserve not "available" in this respect.

However the UK implementation of this provision is tighter (in some respects at least),[138] requiring for a public company that a distribution –

(a) must not exceed the excess of its net assets (ie its assets net of liabilities and of provisions for liabilities and charges) over the aggregate of its called up share capital and undistributable reserves (defined as share premium account, capital redemption reserve, a reserve for net unrealised profits and any other reserve not to be distributed by law or the company's constitution);[139] *and*
(b) must not exceed its distributable profits – ie its accumulated realised profits (not already distributed or capitalized) less its accumulated realised losses (not already written off in a proper reduction or reorganisation of capital).[140]

The effect of this in our context is that since –

(i) the reserve established for the share option is not one of those mentioned on the list of undistributable reserves for the purposes of (a);
(ii) nor is it a provision for a liability or charge as defined (see above) nothing in (a) prevents its distribution.

So far as (b) is concerned, the key question is whether the reserve represents "realized profits".

Ex hypothesi, when the reserve was set up it was matched by realised profits (leaving aside any accumulated loss, which would of course anyway require to be covered before any distribution could take place).

The only question therefore is whether the issue of the share option and related accounting transactions should require the relevant profits to be treated as no longer realised. There appears to be no reason to do so: there has been no loss of assets to the company, nor change in the character of its assets; the original transactions which gave rise to the realised profits remain unaltered; there is no risk to creditors in distributing the reserve. The reduction or exhaustion of the reserve on distribution will correspond to the reduction of assets in respect of that distribution. The balance sheet will not provide any less of a true and fair view of the financial position. The reserve merely records that a certain movement on profit and loss account, which was treated as reducing earnings, led to no reduction of assets and therefore no reduction in equity. In so far as it signifies anything for investors it merely reflects the value at a particular point in time of the undertaking given on behalf of shareholders to accept a dilution in their shareholding. But there is no need to retain a

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[138] A question arises about the translation into UK law of the Directive expression "losses brought forward" as the arguably more limited "realized" losses, but the issue is not material to this report and it is now 23 years since the UK implementation without any challenge on the point.

[139] Sec 264 CA 85.

[140] Sec 263 CA 85.

reserve on the balance sheet to indicate this point; as a matter of disclosure, in UK accounting law and practice the existence of outstanding share options will emerge from the notes to the accounts.[141] There is therefore no case, either in accounting presentation and transparency, or in prudential terms, for requiring its retention.

There is a counter-argument, that the provision in the Second Directive for "reserves available for this purpose" to be added into the equation of net earned surplus under Article 15(1)(c) should be regarded as limited to accumulated surpluses of realised profits which have been carried to reserve.[142] However this counter-argument is not at all persuasive, for at least four reasons: first there is nothing explicit or implicit in the Directive to suggest that this is correct; second, the provision has apparently been interpreted in the opposite sense throughout its life by certain Member States, which took that opposite approach at the time of its adoption, by treating share premium account as an available reserve.[143] Third, if this were the effect it would be difficult to understand the separate net assets test.[144] Fourth, even if there were force in this argument, there remains the point that the reserve set up in respect of the option expense still represents part of the accumulated surplus of realised profits for the reasons set out above, so that there is no infringement in principle of the alleged strict earned surplus test.

An alternative approach is to disregard the charge to profit and loss account in its entirety for distribution purposes on the ground that it does not represent a loss *of the company*. The acceptability of this argument depends on one's perspective. From the accounting point of view, the concern for comparability and recognition of the real economic costs of the employment relationship for the enterprise leads to the conclusion that the charge is to be treated as the company's loss.[145] From the legal perspective, the company has incurred no liability and will not suffer any loss of assets if and when the option is exercised. However the effect of the Directive is very arguably to make the accounts overriding in determining this question.[146] The argument based on the availability of the reserve as distributable seems, therefore, both safer and preferable.

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141 Secs 226-227, 230, 263 CA 85 and Schedules 4, para 40 and 4A para 1. However there is no corresponding provision for small companies in Schedule 8.

142 Or treating distributability of profits by reference to the surplus on all profit and loss accounts, treated as a running account over time – the approach favoured by the British Jenkins Committee in 1961, Cmd 1749, para 350, and adopted by the Aktiengesetz in Germany.

143 Some of which, as noted above, regard the reserve established for share premiums as available for distribution. See ch 2, above and the accounts of the laws of France, Italy and Spain in Annex C.

144 Share capital and share premium would not be distributable. The omission of share premium from the undistributable reserves would be hard to understand

145 See the IASB rejection of this approach in IFRS2, BC 34–35.

146 As noted above, there is some doubt whether the net earned surplus test under the Directive Art 15(1)(c) Second Directive is to be referable to the accounts, but the safer view is that it is, and this is the approach of the UK Act.

Conclusion and Recommendation

In our view therefore, even disregarding this alternative approach, the accounting treatment required by the new proposed standard on employee share options does not necessitate, either as a matter of European or UK law or of policy, that the amount of a company's distributable profits should be reduced by the amount of the charge, required for reasons of good accounting, to the company's profits and loss account; nor should the reserve, which arises in the balance sheet in consequence, be regarded as undistributable or as representing unrealised profits. Neither EU Directives nor the British Act have a contrary effect. This is also entirely appropriate as a matter of economics; distributions which make no allowance for the relevant charge to profit and loss account present no threat or risk on that account either to creditors or to shareholders.

However this conclusion may well be regarded as surprising and unexpected having regard to the apparent objective of the Second Directive, ie to limit distributions to the accumulated balance of company earnings, as recorded in its profit and loss accounts, treated on a running account basis. So although, given the underlying economic realities, we regard this result as both appropriate and in keeping with the letter and the objectives of the Directive, we nevertheless believe that, at least for the UK, there is a case for authoritative guidance to the effect that this is the position. Such guidance could properly be issued by the Institutes of Chartered Accountants in England and Wales and in Scotland, which have recently issued guidance of a somewhat similar kind as to whether reserves arising on a reduction of capital, for example, are to be treated as distributable and as representing realised profits.[147]

We accordingly recommend that the Institutes should issue such guidance.

We believe that there is also a need for such guidance at Community level and would accordingly invite the Commission to consider issuing similar guidance.

It must be noted that the position under the domestic law of other Member States, which link distributable profits strictly to the accumulated net surplus on profit and loss account, may be less able to accommodate the new standard.[148]

Afterword

The above analysis is needed because European law rigidly links a decision about the economic prudence of a company transaction to the company's results as stated in its main accounting statements. The accounts however are designed to enable investors and creditors to evaluate the company's real underlying economic position and performance without being tied to strict legalities or the form of transactions ("substance over form"). This approach to accounting is, we believe, one of the strengths of the European tradition. Rigid linkage of distribution rules to such

147 ICAEW, TECH 7/03 see <www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_49105>.

148 This may well be the position in Germany, see Annex C.

accounts can give rise to difficulty. The difficulties in relation to share options can be resolved without a need to change the law (in the UK at least). But the same cannot be said of other standards, including the proposed standards on pension fund deficits, to which we turn in the next chapter. It must be recognized that a change in the law to deal with such deficits would also remove any residual doubt on stock options. This would of course be desirable, and may be necessary in other EU Member States.

Chapter 4: Pension Scheme Deficits and Distributable Profits

Existing UK accounting standards will in due course require pension scheme deficits to be recognized on the face of company accounts and a similar result may arise under future IASs.[149] Similar issues arise about the impact of such recognition on the powers of companies to provide a return on share capital through distributions as those considered in chapter 3 on share options.[150]

Background: Pension Schemes and Company Liabilities

Company funded[151] pension schemes are essentially of two kinds –

a) defined benefit schemes, where the employee is entitled to a predetermined amount on retirement, usually primarily an annuity equivalent to some proportion of final salary. The employing company and the employee are usually legally obliged (or sometimes in the case of the employer, not obliged, but expected) jointly to fund the pension. The employee normally contributes at a fixed contractual rate, corresponding to a proportion of remuneration, while the employer is liable at a variable rate, corresponding to its obligation to make good deficiencies in the fund if the performance of the assets fails to match the expected liabilities; and
b) defined contribution schemes, where employer and employee contribute defined amounts to a fund and the employee is entitled to the proceeds of the contributions invested on his or her behalf.

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[149] IASB has very recently tentatively decided to add an option to IAS 19, on Employee Benefits; this would allow accounting similar to FRS 17, on Retirement Benefits, see IASB Update, Dec 2003. At its March 2004 meeting IASB discussed a draft exposure draft to this effect.

[150] Since these accounting standards do not change the legal or economic character of the costs of pension schemes it is debatable whether these problems are not already an issue. However this Report proceeds on the assumption that current practice, which allows pension fund deficits to be "spread" and recognized over time, is legally acceptable.

[151] Recognition of a liability to pay a pension necessarily requires its funding by the accumulation of assets. In the UK this is normally done by setting up a separate trust to hold the fund with the pensioners and contributing employees as beneficiaries. However the principles considered in this chapter would appear to apply to any funded pension scheme, whether or not there is a separate trust.

Thus for a) there may be deficiencies, which are at the risk of the employer. There may also be surpluses, which (so far as they are for the benefit of the employer) result either in his being relieved for a period of his obligation to contribute (a "holiday") or, rarely, the fund reimbursing the employer. For b) there can be no deficiencies or surpluses and the risk as to performance of the fund rests with the employee.

Our concern is with companies subject to the Companies Act as employers[152] (and of course with similar companies elsewhere in Europe). Defined contribution schemes present no particular difficulty. Any expenditure by a company in funding such a scheme during the period will be treated as a pension cost and any difference between the amount paid over and the contributions due for the period will be treated as a liability or prepayment in the balance sheet.[153] But defined benefit schemes, where the company is liable, or as a matter of commercial reality can be expected, to fund a deficit raise more difficult and complex problems.

Any such deficit or surplus will represent the difference between the values of –

a) the scheme's expected liabilities, which will be a function of the expected and actual costs over the scheme's life deriving from: contractual benefits; life expectancies; changes in pay rates; amounts to be paid out for pensions already in payment; other inflationary changes; likely volatility in the labour force; and other factors, with the application of an appropriate discount rate to all these liabilities to reflect their crystallisation over time; and
b) the scheme's assets, which will be a function of the expected return from them over time.

This difference will, under UK practice, be established periodically by the scheme's actuary, who will value the liabilities and agree an appropriate rate of contribution by the employer, sufficient prudently to make good deficits or erode surpluses.[154]

UK Standards

Under the relevant UK accounting standard[155] various losses and gains are to be reflected in the profit and loss account, including the following –

a) "Current service cost" – ie the increased liabilities resulting from employee service within the accounting period;
b) "Interest cost" – ie the increase in the liabilities as a result of their being one

[152] Or as companies with an obligation to provide employee benefits although not technically the employer – eg holding companies in relation to their subsidiaries' employees, or vice versa.

[153] ASB Financial Reporting Standard 17 (FRS 17), para 75.

[154] There may be tax penalties as well as company costs involved in maintaining excessive surpluses.

[155] Financial Reporting Standard (FRS) 17, paras 50-74.

year nearer to payment, reduced by the expected return on assets over the period (the result may be either a cost or a gain);

c) "Past service costs" – ie changes to scheme liabilities resulting from changes in benefit terms (eg the introduction of an enhanced widows' benefit).

In addition various gains and losses will be recognized in the Statement of Recognized Gains and Losses (STRGL). These will include "actuarial gains and losses", which may result from changes in the value of the assets, or changes in the actuarial value of the scheme liabilities, which may often result from differences in actuarial assumptions and valuations, including, crucially, changes in the discount rate.

Certain further recognition of costs is required which is not central to this report.[156] Any asset which results from a right to any surplus in a scheme, and any liability to fund a scheme in the future, and any changes in these items, must of course also be recognized in the balance sheet.[157] Extensive disclosure is also required in the notes.

The largest and most volatile of these items is often actuarial gains and losses, which FRS 17 requires to be reported in the STRGL rather than in profit and loss account.

Where a defined benefit scheme operates for more than one employing company (a "multi-employer scheme") it may be impossible for a particular employer to calculate its separate deficiency. In these circumstances FRS 17 allows the company to account for the scheme as if it were a defined contribution scheme while disclosing the facts and any available information on the surplus or deficit. Where the employers concerned are companies within a group the exemption will not apply to the group accounts which can be compiled as for a single employer, consolidating the deficit or surplus.[158] However since distributable profits are calculated by reference to individual accounts the effect will in all such cases be that there is no effect on distributions. The result is of course anomalous – a deficit which is too uncertain, in terms of its allocation to a particular company, to be included in the balance sheet, however large it may potentially be, will not reduce the distributable profits, while a small but certain deficit will – see below.

Many companies would, if they applied this standard in present conditions of low equity values and low expected returns, and low interest, and thus discount,[159] rates be showing substantial losses and perhaps even technical[160] insolvency. The overall liability of British companies for such deficiencies has been estimated recently as

[156] FRS 17 paras 64–74, for example death in service benefits may be insured (actual expenditure) or may be provided for as a scheme benefit, subject to actuarial valuation and of course expensed to the scheme when paid, see para 74.

[157] FRS 17 paras 37–49.

[158] FRS 17, above, paras 8–12.

[159] Clearly the lower the discount rate applied the higher the value of long-term liabilities.

[160] This is not a term of art, but here means a net book deficiency of assets over liabilities.

between £160 billion and £300 billion, but is currently declining. The position has been very volatile in recent months.[161] A reduction of distributable profits of this magnitude can be expected to have a devastating effect on companies' capacity to remunerate shareholders, with consequent effects on their capacity to finance their business and cost of capital. For investors, savers and pensioners there are likely to be corresponding damaging effects on share values, levels of savings linked to shares, and indeed the performance of mutual funds and pension funds themselves.[162]

In November 2002 the ASB modified FRS 17 by providing, inter alia, that its requirements to measure pension costs on a FRS 17 basis and to include actuarial gains and losses in the STRGL, and to make corresponding balance sheet provision, need not be reflected in main financial statements until accounts struck for periods beginning on or after 1 January 2005. Meanwhile SSAP 24, which requires liabilities to make good deficits to be recognized over an extended period, remains in force for the recognition of pension fund liabilities and costs in the accounts. This postponement was made so as to align the domestic change to the intentions of the IASB, which is now expected to consider revising its own standard. IASB also appears minded to provide for recognition of actuarial gains and losses.[163] The FRS 17 requirements for disclosure in the notes to the accounts are now in force, although the British Institutes have announced by way of guidance that such notes alone have no impact on a company's ability to make a distribution under company law.[164]

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161 Confederation of British Industry "CBI says Pensions Black Hole will harm British Economy", Press Release, 25 July 2003, <www.cbi.org.uk>. The basis of this calculation is unclear; the estimate may include liabilities already recognized by some companies, but such recognition will continue to impact on their profits until the liabilities are satisfied. A more recent assessment values the deficit on the FTSE 350 pension schemes at £75 billion at the end of November 2003 having shrunk from £135 billion in March. Smaller companies' deficits are typically much greater as a proportion of liabilities than large ones' – research by Barrie and Hibbert reported in Financial Times, financial markets supplement, 1 Dec 2003, 5, and 8 Dec 2003, 2.

162 Other rules and government proposals to tighten the law on company liabilities to fund pension schemes will have an impact on particular companies. See Secs 56 to 61 and proposed regulations under Sec 75 Pensions Act 1995. See White Paper, Department for Work and Pensions, *Simplicity Security and Choice*, June 2003, Cm 5835. The new liabilities will be contingent on a pension scheme winding up and will not affect distributable profits until they become vested, but will deter such winding up and thus tend to lock FRS 17 deficits into company finances.

163 See ASB, Amendment to FRS 17, Nov 2002, Preface, and IASB, Employee Benefits (Convergence Topics), March 2003 (rev. 2003/03/04) at page 2: the Board has "tentatively agreed that actuarial gains and losses should be recognized immediately, ie that the corridor and spreading options within IAS 19 should be removed". The IASB has also considered an exemption for individual companies participating in group pension schemes, broadly similar to that in FRS 17, discussed above.

164 ICAEW, ICAS TECH3/02, <www.icaew.co.uk/> above.

Legal Consequences (1): Accounts

The accounting treatments prescribed by the Act for the application of FRS 17 are generally described in an annex to the standard.[165] The critical commercial point is that actuarial gains and losses are to be included in the statement of recognized gains and losses, but all the items mentioned above at a) to c) and also the recognition of actuarial gains and losses, will have an impact on a company's reserves to the extent that they are increased or depleted by recognizing pension surpluses or deficits. This is on the basis that pensions deficits are recognized as provisions in the sense that they reflect not actual expenditure but amounts –

> "retained as reasonably necessary to provide for a liability the nature of which is clearly defined and which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise".[166]

Legal Consequences (2): Distributions

Effect of the Second Directive

As noted in the preceding chapter, Article 15 of the Second Directive requires public companies' distributions to satisfy both of two tests, a balance sheet net assets test and a net earned surplus test –

a) the former requires that a distribution must not exceed the excess of the net assets in the accounts over "the amount of the subscribed capital plus those reserves which may not be distributed under the law or the [company's articles]", all as stated in the latest annual accounts;

b) the latter requires that "the amount of a distribution may not exceed the amount of the profits at the end of the last financial year, plus any profits brought forward and sums drawn from reserves available for the purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the [company's articles]".

b) is not expressly linked to the accounts, but it seems arguable that that is intended.

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165 CA 85, Schedule 4 requires separate itemisation of pension liabilities in balance sheets and pension costs as a separate item under staff costs, or included in staff costs but separated out in a note (para 56(4), particulars of staff). Para 50(4)(a) requires disclosure of particulars of pension commitments within any balance sheet provision, and 50(4)(b) disclosure of commitments for which no provision has been made (with separate disclosure for past directors' pensions).

166 Act of 1985, Schedule 4, para 89, as to be amended in the Modernization process, see ch 3. (In fact some components of the relevant liabilities are certain to arise and some only likely to do so and various components are uncertain as to amount and/or date). But note that FRS17 – see para 47 – specifies the presentation of a liability on a defined benefit scheme by reference to the formats, as a separately identified liability, and does not in terms require it to be shown within provisions.

In our view movements on provisions for pensions as stated under FRS 17 will reduce or increase the net assets for the purposes of a) to the extent that these have an effect on the company's reserves (and any asset corresponding to a surplus will increase them to that extent). The Directive does not define net assets, but it is clear that the reference is to assets net of liabilities and this must be intended to include provisions for liabilities – it would be perverse to treat the assets as intact merely because the liabilities are uncertain as to amount or date of incurrence so that they are to be dealt with by a provision, rather than strictly by a liability. FRS 17 does not require these to be shown as provisions—but this does not in our view affect the conclusion.

So far as test b) is concerned, charges or credits to the profit and loss account will reduce or increase the profits available for distribution under b), but it is less clear whether such charges and credits to the STRGL will have the same effect. However it seems very strongly arguable that the amount of the profit for the year is to be struck after taking account of pensions costs, whether these arise as actual expenditure or by way of provision.[167]

Effect of Companies Act 1985 Part VIII

The Directive net assets test is implemented for public companies by Section 264, which makes it clear that net assets means assets net of liabilities and that liabilities for this purpose include provisions for liabilities within the meaning of schedule 4. It seems very clear that any FRS 17 compliant provision for a pension fund liability will reduce the net assets available for this purpose.[168] (Thus Parliament interpreted the Second Directive net assets test in the sense suggested above.)

The Directive net earned surplus test is implemented for both public and private companies by Section 263 Companies Act 1985, which requires that a distribution may not exceed the distributable profits – ie the accumulated realised profits so far as not previously distributed or capitalized, less the accumulated realised losses, so far as not lawfully written off in a capital reduction or reconstruction. It is not entirely clear whether the inclusion of a charge or credit by way of provision for an increase or reduction of pension fund liabilities in any accounting period will increase or reduce the net profits, or in the UK the net realised profits, for the purpose of this test. Under the Act it is a question for generally accepted current

[167] FRS 17, appendix ii, para 5 raises some doubts on this issue. It seems clear that the service cost is regarded as the pension cost for the period. Arguably the standard anticipates that items reported as a loss in the STRGL are not part of the profit for the year. But this does not appear sustainable when considering the Community law legal question whether such losses are Art 15(1)(c) Second Directive losses for distribution purposes – see below. The draft guidance on the implication of FRS 17 issued by the Institute of Chartered Accountants in England and Wales on 15 April 2004, certains the view adopted in the text.

[168] DTI propose to amend Sec 264(2) CA 85 to have a similar effect for IAS provisions, see DTI and HM Treasury Modernization Consultation, above, Annex D, Schedule 1, para 22.

accounting practice whether a profit or loss is to be treated as realized. However given the effect of the Directive it seems extremely difficult to envisage the profession taking the view that pension fund provisions are not realised. In our view such provisions clearly represent a realised loss, which should be taken into account under Section 263.

Conclusion on Legal Consequences – A Need for Urgent Reform

It seems clear therefore that, as a matter of both domestic and European law, the inclusion in the balance sheet of the provisions for pension liabilities, as required by FRS 17 and likely to be required by IAS, will have the effect of reducing a public company's distributable profits to the relevant extent. Whether such a provision also reduces the earned surplus for the purposes of the net realised profits/ accumulated profits test (which applies to all companies, public and private) seems somewhat more debatable. But we believe that it does. If the point on net assets is sound the issue on the earned surplus test is of course an academic one, except for private companies under domestic law. However even for public companies the point will need to be taken into account when it is considered what amendments would be required to make the damage (if indeed it is regarded as such) good.

It is in any event quite clear that to reverse this result both UK and Community legislation will be required, and it would be desirable to put both points beyond doubt.

Reform the Law or Reform the Standards?

It may be suggested that the difficulties identified here and in the preceding chapter could be resolved by the adoption of different accounting standards. This does not appear to be a realistic approach. The IASB adopts accounting standards to satisfy the needs of investors worldwide for the highest quality financial information. The difficulties considered in this report arise because of the inflexible adoption of that information to calibrate a rule which serves a different purpose, control of imprudent distributions. Predictably, this confusion of purposes leads to unsatisfactory results. It should also be recognized that company accounts convey information not only through the balance sheet and profit and loss account but also through the notes to the accounts, and increasingly through other statements.[169] Yet it is only these two selective statements, which inevitably only summarise and provide a certain limited perspective on the overall financial picture,[170] which are invoked to set the amount fit for distribution.

[169] Such as the operating and financial review.

[170] Note, for example, that under the standards described above on pensions, where under a multi-employer scheme an employer cannot calculate the deficit attributable to him, the disclosure will be in the notes, leaving the deficit completely out of account for distribution purposes.

Nor are the accounting standards on options and pensions the only ones which can be expected to give rise to such difficulties. Similar problems are already emerging in the areas of accounting for financial instruments and for deferred tax.[171] The problem is systemic. The only viable solution appears to be for Europe to establish its company law on a basis better suited to achieve the policy results required.

But reverting to the main subject of this chapter, we regard the case for amending domestic and community law to remove the automatic effect of the newly required recognition of actuarial pension deficits on companies' capacity to make distributions as a strong and urgent one. So long as a company can safely be regarded as a going concern, the fact that it will have to make substantial payments over time to fund its pension scheme, just as it will have to fund its workforce for wages and to meet other ongoing liabilities, should not affect its immediate financial capacity. To require otherwise will damage companies, the capital markets and even the very employees whom pension funds are established to protect. In particular the application of traditional capital maintenance doctrine provides a further disincentive for the maintenance and establishment of defined benefit pension schemes, which alone provide employees with a secure prospect of income on retirement.

There is no suggestion here that appropriate prudential standards should not be applied to distribution transactions, nor that, where companies have pension scheme deficits, proper account of these should not be taken in deciding on distribution policies. But the automatic effect of the Second Directive and the implementing UK legislation, in attributing such deficits to distributable profits (or surpluses) is crude and inappropriate. Better means must be found to give creditors proportionate protection against insolvency risks, which is their only legitimate concern.

It is we believe clear from our overall assessment of the capital maintenance regime in chapter 2 that there is a strong case for reform. The position on stock-options, which emerged in chapter 3, while capable of being met by authoritative guidance in the UK, is scarcely satisfactory. It raises uncertainties in this country and probably greater difficulties in some other EU Member States. But it is clear from our analysis of pension deficits in this chapter that reform is urgently needed.

In the next chapter we make recommendations for reform of EU law to address these problems, or failing that, less comprehensive change in UK law, at least to reduce their impact.

[171] IAS 39, on Financial Instruments: Recognition and Measurement, requires and permits a wide range of financial assets and liabilities to be stated at fair value, and many would question whether all changes in fair values are relevant in the context of distributions. IAS 12, on Income Taxes, in many circumstances requires larger liabilities for deferred tax to be recognized than currently required under the corresponding UK standard. Particularly where such liabilities do not fall due for an extended period, their economic relevance for distributions is also questionable.

Chapter 5: A Proposed Regime – Europe and the UK

The Approach to a Better Regime

So far this report has identified a number of defects (some of which threaten to be very damaging for companies and their stakeholders) in the present UK and EU company law provisions designed to protect creditors from imprudent transactions which result in the return of company assets to shareholders. In spite of those defects however, the case for such special creditor protection is recognized in almost all[172] the legal systems we have examined and we argue below that there is a case for it. While the transactions in question also raise shareholder protection issues, we have not identified major weaknesses in the UK and EU regimes in that regard and do not make any related proposals. Our concern is creditor protection.

Part I of this chapter considers the legitimate interests of creditors which require protection and the principles which should ideally apply to the design of a better regime.

Part II then develops the details for such an alternative proposal on the assumption that we are free to design a better regime on a clean sheet basis – ie that it is possible to reconsider the EU regime. However this may not prove politically possible.

Part III of the chapter therefore considers what could be done, within the limits of EU law, to improve the UK regime.

An important consideration, in both the EU and UK context, is to ensure that a fair resolution is achieved to the particular problem identified in chapter 4, the impact of pension fund deficits. But it must be recognized that this problem is merely an example of the difficulties raised by linking two sets of rules with increasingly divergent objectives: distribution rules, designed to ensure prudent overall judgements in the interests of creditors, and accounting standards, designed to achieve optimal financial information for the markets, primarily on the basis of historical information.[173] In this connection it also needs to be borne in mind that this linkage is only to the balance sheet and profit and loss account, which are inevitably selective, rather than the whole of even the company's historical financial statements.

There are many other aspects of the present regime which present unnecessary or disproportionate difficulties to businesses and investors, as described in chapter 2. Any new arrangements should so far as possible avoid all these difficulties, without of course creating countervailing new ones.

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[172] In some US states, eg Massachusetts, company law relies entirely on rules which apply generally to provide creditor protection with no special provision for returns of assets to shareholders, see B Manning and J Hanks *Legal Capital* (3rd edn Foundation New York 1990) 64, 65; this approach is also considered, but rejected, below.

[173] As pointed out in ch 4, other IAS are calculated to lead to similar problems.

Part I. Creditor Protection and Shareholder Returns – Basic Principles

The key legitimate interests of contractual creditors[174] are –

- freedom of contract, as to whether or not to enter into credit transactions and to lay down the terms of the relationship on an agreed basis
- sufficient information on the basis of which to contract (including making appropriate provision for the credit risk) and exercise powers to protect their position and
- a fair prospect (having regard to the contractual risk and reward) of being paid.

We are directly concerned with the last of these (which indeed largely subsumes the others), and only in the context where the creditors' interest in being paid is in conflict with shareholders' rights to receive a return. But the level of information and the ability of creditors to contract are highly relevant in determining a fair measure of protection for creditors here.

The Core Creditor Interest – Solvency

The key issue is however the threat of insolvency, since this is the only condition in which creditors will be left unpaid. It is neither possible nor desirable to provide absolute guarantees against insolvency. Any return of assets to shareholders increases the risk to creditors; but without a return for investors, companies could not perform and contribute to general welfare, and even creditors would not be in business at all. It is thus a question of reasonable balance, or proportionality. This balance must be struck taking account of the conditions in which modern business is conducted and all the other provisions of company law and practice which create risks or added security for creditors.

Wherever possible, however, rigid or restrictive rules which impede business, in circumstances where this is not justified in terms of preventing disproportionate risk to creditors, should be avoided. This suggests that the fullest possible advantage should be taken of disclosure law, which does not inhibit business freedom, and general legal standards of business conduct, which can adjust to take account of the balance of the particular case, rather than rigid prohibitions or limits on corporate financing decisions. To repeat, the law should focus on the core risk at stake – insolvency.

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[174] We considered involuntary creditors (eg tort victims) in ch 2. They do not rely on capital reserves and they benefit from any general protection provided to contractual creditors. Their interests, which are essentially a fair prospect of solvency, are also covered in this ch.

Certainty and Safe Harbour

A final consideration is certainty in favour of companies and their management. Any rule needs, ideally and so far as possible, to be subject to sufficiently concrete tests to enable company directors and controllers to have sufficient certainty as to what is permissible when they make decisions about distributions and other returns to shareholders. We have considered whether such certainty can be achieved, without the rigidities identified in the UK and wider EU system, if provided as a conditional, or "safe harbour", requirement.

The same considerations do not apply to require certainty for creditors; they need legal security; but this can be achieved by an appropriate standard; the directors and controllers making the distribution decision need the safe harbour**.**

Part II. A Fresh Start – Replacing the Basic Doctrine

If this is the objective, what are the key criteria which we need to apply in designing a regime which ensures a fair prospect for creditors of being paid while allowing to shareholders a similar prospect of return on their investment?

First, as noted, these two objectives do not diametrically conflict. It is normally in the interests of creditors that a company should have the means of raising share capital and this requires that share capital should have a fair prospect of a return.

Next, it has to be recognized that the question of where to set the balance is not a purely logical one. It is a matter of judgement based on experience, bearing in mind that as a matter of economic welfare the restrictions on freedom of contract and of disposition of property should be set at the minimum necessary to protect interests which cannot be expected to be efficiently protected in the market.

This leads at once to the key questions, which focus on the distribution rule – in what conditions is it legitimate, in the cause of creditor protection,[175] to restrict a company's freedom to pay a return to its shareholders? If the core objective is to avoid unreasonable risks of insolvency and this is to be achieved by use of the minimum of restrictions, what can we learn from experience to provide the answer?

After addressing these questions, consideration can be given to the case for the ancillary rules which support the legal distribution policy. These currently regulate publicity for capital reserves, the quality of such reserves when raised, and the writing down of such reserves. Finally we need to look again at the allegedly related problem of financial assistance.

As has been pointed out, the definition of an optimal distribution rule in any jurisdiction will depend on the context – ie the disciplines applied in practice by other rules which protect creditors. It therefore seems appropriate to consider the question, what is the optimal clean sheet solution, first in the context which is most

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[175] We are not of course concerned with other grounds for restraining the distribution of assets, for example because reserves are best retained for investment, growth or acquisitions.

familiar to the Group, ie Great Britain. The next question is how such proposals may need to be modified to set appropriate minimum standards for the EU.

An Efficient Balanced Distribution Rule – Learning From Experience

Classes of Distribution Rule

As is evident from the comparative material in Annex C, distribution rules have various possible core components, which can be divided into 4 broad classes:

Class 1. "Solvency standards", which require distributions to be set at a level which does not undermine the solvency of the business;

Class 2. Rules which prohibit more than a surplus of assets over liabilities from being distributed, but allow the whole of any such surplus to be distributed ("net assets", or "bare net assets" rules);

Class 3. Rules which prohibit more than a surplus of assets over the aggregate of liabilities, taken together with an additional reserve, from being distributed ("net assets with margin", or "enhanced net assets" rules);

Class 4. Rules which prohibit more than the operating profits from being distributed ("earned surplus" rules).

Cumulation and Combination of the Rules

Many jurisdictions combine such restrictive rules by requiring either a cumulation of them, or perhaps allowing them as alternative gateways to the making of a distribution. For example, the Model Business Corporations Act and the New Zealand Companies Act both require a cumulative solvency and bare net asset test. California allows either an earned surplus test or a, somewhat esoteric, net assets with margin test. Delaware requires a default[176] bare net asset test, but allows an alternative "nimble dividend" gateway.[177] The EU requires a cumulative "enhanced net asset" and "modified"[178] earned surplus test (both tests applied with variable content in the different Member States).

Voluntary Adoption of Stricter Rules

In many jurisdictions the law explicitly allows the adoption of stricter rules than the minimum; for example Delaware allows a Class 2 (bare net asset) rule, but explicitly allows companies to adopt par values and/or "stated" capital, thus adopting a vol-

[176] "Default" because the test may be enhanced autonomously – see below.

[177] See Annex C. The California rules also operate in Alaska. Note also that the California earned surplus test operates on the basis of directors' appraisal. See B Manning and J Hanks *Legal Capital* (3rd edn Foundation New York 1990) 176, 177.

[178] Modified in the sense that Member States are free to add available reserves to the earned surplus. See generally chs 3 and 4 above.

untary Class 3 (net asset with margin) rule. The EU regime[179] requires a net asset with margin rule – the margin being "subscribed capital"- but explicitly allows either Member States or companies to impose additional requirements for non-distributable reserves, thus enhancing the margin. Obviously such company options can be exercised, under relevant Member State law, by agreements between companies and shareholders or creditors.

Asset and Liability Recognition

Jurisdictions also differ about the extent to which they allow assets to be recognized. Are increases in value which arise on a revaluation of assets, but which have not been established by a trading transaction ("unrealized profits"), to be treated as assets which count towards any particular test? Similarly are unrealized losses to be treated as reducing such assets? May assets which do not appear on the balance sheet (eg goodwill or brands) be treated as assets?

Similarly with liabilities, some jurisdictions allow the real value of liabilities to be a matter of appraisal, or assessment, by those responsible for determining the distribution. This may take the form of genuine valuation (normally by discounting in the case of future liabilities) or a more subjective appraisal of a liability to take account of the impact on the business over time and the significance of the threat it presents to the going concern. Here again, the approaches offered may be in the alternative – for example under the MBCA guidance the directors may rely on the properly prepared company accounts for determining values, or they may rely on a more subjective appraisal.[180] Here again a question arises about "off balance sheet" items. Must liabilities which do not appear there (eg, often, contingent liabilities) be taken into account?

A Nimble Dividend Exception

Finally these core tests are relaxed in some jurisdictions by the adoption of a "nimble dividends" exception which allows a company which fails to satisfy the other tests to distribute current profits where the recent current performance is profitable. The most prominent example is Delaware.[181] However it seems clear that this exception should not override the basic solvency requirement.

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[179] Art 15(1) Second Directive.

[180] See the MBCA guidance described in Annex C and compare the New Zealand rules. The same is true for Canada, in the context of a quite strict stated capital regime.

[181] Annex C, Model 8, B.

The Optimal Distribution Regime: (1) – Starting from Solvency

Basic Creditor Protection

Since the basic interest of creditors in contexts where assets are to be returned to shareholders is a fair and proportionate protection against threats to solvency, the logical starting point is with the general rules which prohibit undue risks to solvency. All systems have such rules, sometimes as part of insolvency law and sometimes operating more widely. In the UK the key provisions are the insolvency law concerning transfers of assets in the period before insolvent liquidation (sometimes known as the “suspect period” rules) and the “wrongful trading” rules, which impose liabilities on directors who fail to take all reasonable steps to protect creditors when there is no reasonable prospect of avoiding the threat of insolvency.[182]

The directors’ general and continuing duty of loyalty is also relevant – it is not in the interests of company success to run a disproportionate risk of insolvency. Under British law the Second Directive tests are supplemented by a duty on directors not to make distributions which imperil solvency.[183] This is reinforced where, as in Britain, the directors, who have a self-interest in company survival, are also the determining influence in practice on distribution decisions; the classic agency relationship is less under strain here than in many other contexts.

Indeed there may be a strong concern in the other direction, that the directors may be more inclined to harbour assets under their own control within the company than to return them to shareholders. This may explain the absence of major scandals involving excessive distributions.[184]

The Winter Group believed a wrongful trading regime was desirable throughout Europe, as a basic component of creditor protection and corporate governance generally, but with particular relevance for distribution regimes.[185] We agree.

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[182] See Annex C, particularly the discussion of fraudulent transfer laws under the Model Business Corporations Act, Model 7 at E.

[183] *Flitcroft’s Case, In re Exchange Banking Co,* 1882 Ch D 519 CA (preservation of capital, as what creditors “give credit to”, per Jessel MR), and case law on duties of directors when insolvency threatens, cited below on remedies against directors. This remains in effect where not inconsistent with the Directive regime, Sec 281 CA 85. The CLR proposed codification, widely welcomed by business and endorsed by Government – Final Report, op cit, Annex C. We recommend that a general solvency requirement should be preserved in the UK and formalised through certification and adopted throughout the EU – see below.

[184] Consider the number of cases of abuse of distribution powers against the number of sections (95) in the Act regulating capital maintenance – might this be the most over-regulated field in company law?

[185] Winter Report, op cit, 68–69. The Commission Action Plan, above, supports this but for the medium term, page 16.

Adding to Basic Creditor Protection

Are such general creditor protection provisions sufficient in the distribution context, given in particular the fact that directors' motivations may mitigate further the risk of over-distribution, at least in the UK? While some jurisdictions adopt that view, we do not believe, on balance, that this is wise. Distribution cases raise particular risks for creditors which do not arise in the context of normal trading decisions, because of 3 related factors:

– there is an outflow of assets from the company for no incoming consideration;
– the normal restraint on management, via the desire of shareholders to secure that undue risks are not taken, may often be much reduced, or even absent, because the shareholders normally stand to benefit immediately from the distribution; and
– the normal mechanisms of shareholder governance are compromised.

It is notorious that as the risk to creditors increases, so the interests of shareholders and creditors tend more widely to diverge.[186]

Solvency Certification

These arguments, taken together, probably on balance justify additional protections, but these must, as we have emphasized, be proportionate and not excessive. The best approach, focused on solvency, is that directors who pay or recommend distributions should have their special responsibilities in this context brought home to them. This can be achieved by a mandatory, transparent board level decision agenda, and a clear formal requirement to focus on the merits of the case, (ie the expectation of continuing solvency) creating the conditions for a clearly defined liability to arise where professional care is not properly taken.

This suggests an explicit act, in the form of certification of solvency, as required in New Zealand. In our view this certification should be published by filing on the companies register as in the present British precedents, although this is not required in New Zealand. But very important questions of detail arise as to the content and effect of the certificate. While the New Zealand approach has apparently been very successful in practice and represents experience in an economy which previously applied traditional capital maintenance principles, alternative approaches are also worth considering. Accordingly below we first explore and comment on the New Zealand approach on both solvency certification and on an additional balance sheet test, making suggestions as to how this approach could be adapted to a UK environment. We then look at an alternative approach, based on current British law

[186] See for example the discussion of under-capitalization in F Easterbrook and D Fischel *The Economic Structure of Corporate Law* (Harvard 1991) 59.

and Company Law Review proposals. We finally tentatively conclude in favour of a regime for the UK which owes much to both precedents but which includes some important new suggestions of detail.

Solvency Certification – New Zealand Approach

The New Zealand approach would require that the directors should satisfy themselves on reasonable grounds in compliance with the appropriate standards of professional care that the company is, taking account of the distribution proposed (a hypothesis which must obviously apply to any solvency test), a going concern with a reasonable expectation of meeting its liabilities, and should publicly declare their satisfaction in a published certificate. Following this approach, liabilities should include all existing liabilities, including contingent liabilities.[187]

Appropriate and effective civil liability rules should attach to failures to meet the relevant professional standards. There should also be liabilities on shareholders to repay the company where distributions are made without justification, as well as liabilities on the decision-makers. The British approach bases both kinds of liability on fault.[188] However the similar regime in New Zealand imposes criminal liabilities for defective certification and a strict liability on shareholders to the company, with relief only where they show that they have received the distribution in good faith, and have changed their position, and that it would be unfair to insist on recovery.[189]

There is a strong case for a fault based criminal liability for serious cases of defective certification. The normal limitation of liability period which would apply to the civil liability is six years. One important effect of the criminal regime, which should in the UK also attract the court's discretionary jurisdiction to disqualify,[190] would be to provide a sanction in relation to events which occur more than 6 years

[187] For the legal definition of contingent liability see below. In New Zealand contingent assets matching such liabilities may be brought into account. This apparently implies that other contingent and future assets should not be – see Sec 4(4) New Zealand Companies Act 1993: "in determining the value of a contingent liability account may be taken of – (a) the likelihood of the contingency occurring; (b) any claim the company is entitled to make, and can reasonably expect to be met, to reduce or extinguish the contingent liability".

[188] Except for an insolvent winding up within a year see Sec 76 Insolvency Act 1986. On directors see *Flitcroft's case*, above and *Bairstow v Queen's Moat Houses* [2001] BCLC 531 CA. For shareholders see Sec 277 CA 85 (liability if the shareholder knew or ought to have known of a contravention of Part VIII, but other liabilities preserved). Compare the stricter approach in New Zealand – liability unless "unfair", etc to recover – see Annex C Model 11. This has some attractions. Directors' liability for the repayment of the whole of a dividend where shareholders are not at fault may be disproportionate. Sec 727 (relief) should be available but this may require amendment see Company Law Review, above, Developing the Framework, 3.76–77, Final Report 6.2–6.4, and the current DTI consultation on limitation of liability etc for directors and auditors, Directors' and Auditors' Liability, DTI December 2003.

[189] Sec 56(1) New Zealand Companies Act 1993. See Annex C.

[190] Company Directors Disqualification Act 1986, especially Sec 6.

after the making of the certificate, which would otherwise for limitation reasons normally not be actionable. The prosecutor's discretion, combined with the court's discretion on disqualification, should ensure that these criminal sanctions are not threatened except for serious cases.

Audit of the Solvency Certificate

Should such certificates be audited? This is not required for distributions in any existing system. Substantially the same issue was debated in the UK Company Law Review for reductions of capital for private and public companies. The conclusion was that this would be too burdensome and inappropriate; judgements about solvency and going concern are business judgement matters for directors. Probably the most which could be expected of auditors would be certification that they were not aware of evidence that such judgements had been reached on other than proper grounds. This would add expense and delay for arguably relatively little gain (assuming sanctions on directors can be made effective) and would almost certainly not be acceptable for small companies not subject to audit. Audited accounts will normally be available for larger companies and all public ones and we consider below their relevance where they are. We consider the relevance of audit also in that context and conclude that it has a positive role, which is to some extent relevant here.

Reliance on a solvency test of this kind, buttressed by the formality of certification, is consistent with the modern British trend in this field. Solvency certification is the main safeguard (though audit of the certificate is required) in the British Companies Act provisions on purchase of private companies' own shares out of capital.[191] In the Company Law Review, the Steering Group also took the view, after careful consideration and wide consultation, that reductions of capital for private companies[192] should be permitted on the basis of such a certificate, with no additional creditor protection and no audit certificate, and that this protection was adequate in cases of capital reductions combined with distributions of capital, which had the same effect as share buy-backs out of capital.[193] The principle is thus widely,

[191] See Sec 173 CA 85 (private company buy-backs – payment out of capital), adopted in 1981. But note the discretionary court protection on creditors' application in Secs 176–177 CA 85. There are important differences of detail (currently able to pay debts and going concern for coming year) as compared with the MBCA and New Zealand tests (able to pay debts as they fall due). The British rules may have been drawn from the member's voluntary winding up, where stricter requirements, for not only solvency but also one year *payment off* of liabilities, are appropriate – see Sec 89 Insolvency Act 1986. This approach is discussed below. For reversal of the burden of proof of fault, also in that section, see also below. The Winter Group suggested a net assets ("solvency") test combined with a one year net current asset liquidity test, see Winter Report, op cit, 88. Liquidity is clearly important, but indefinitely. Even a short term current asset surplus requirement is too rigid for a company which is able to borrow.

[192] Similar provision for public companies could not be proposed within the confines of the Second Directive without additional creditor recourse, but the same basic safeguard was adopted.

[193] CLR, Completing the Structure, op cit, chapter 7; CLR, Final Report, op cit, chapter 10. See now

though not unanimously, accepted in modern British thinking that transactions economically indistinguishable from normal distributions, so far as creditor protection is concerned, should be regulated by solvency certification, without more.

The Optimal Distribution Regime: (2) – Additional Assets Tests

"Class 2" controls – Simple Balance Sheet (or "Bare Net Assets") Test

The Model Business Corporations Act ("MBCA"), which is arguably the first carefully considered modern treatment of this issue, and the New Zealand regime, which followed it, with additional solvency safeguards, a few years later, both rely heavily on such a solvency test. But both regimes add a class 2 simple net assets test as an additional requirement. In New Zealand certification of solvency is required on both bases.

Is there a sufficient case for this additional obligation?

Arguably the main advantage is that it provides a further discipline which will in practice assist company directors in considering the basis on which they may legitimately decide to make a distribution. (But the additional test is in fact an independent and additional requirement, rather than a gateway, and thus cannot in principle provide any comfort.) The disadvantage is that, because of the linkage to historical balance sheet information, the test is inflexible and not properly linked to solvency. It may thus produce a result which is inappropriate, in either direction. Thus a surplus on a company balance sheet does not necessarily indicate that a company may prudently distribute that amount, any more than that that is the maximum which it would be prudent to distribute. As was established in chapter 4, in connection with pension fund deficits, such mechanical application of a crude balance sheet test fails to make proper allowance for the quality of a company's assets and liabilities, their volatility and linkage over time and the quality of the company's performance. For example, long-term liabilities should be discounted at a realistic rate, having regard to the position of the company, and intangible assets, which are often a major source of cash flows over time in modern economic circumstances, should be assessed accordingly. Conversely off balance sheet liabilities, such as contingent liabilities, and other risks, such as declining markets or order books, need to be properly assessed. Net assets tests are not well suited to covering these important forward looking indicators of the true financial position.[194] These

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White Paper, op cit, para 63(1). This also includes a criminal sanction for making a declaration without reasonable grounds and a one year rule – see below. This is regarded as sufficient to allow buy-backs out of capital with no additional creditor protection, cf Sec 176 CA 85, above.

[194] For example, Sec 4 New Zealand Companies Act 1993 (defining the solvency test) requires (1) that "(a) the company is able to pay it debts as they become due in the normal course of business: and (b) the value of its assets is greater than that of its liabilities, including contingent liabilities"; and (2) requires the directors to have regard to the most recent statutory financial statements and all other matters they know or ought to know may affect the value of the assets and liabilities, including contingent liabilities. They may rely on valuations of assets and estimates of liabilities that are reasonable in the circumstances and in valuing contingent liabilities may take account of the likelihood of their occurrence and any claim available, and reasonably expected to be met, to reduce or extinguish them.

are matters of economic reality, as the frequent phenomenon of market valuation of companies at levels which diverge (in either direction) from their book value amply demonstrates.

Some of these difficulties can be addressed by ensuring that the application of any balance sheet test is not too rigid. As is made clear in the guidance to the MBCA and New Zealand laws, a balance sheet test should operate on the basis that adherence to generally accepted accounting practice and reliance in particular on the going concern assurance by the board certified by the auditor should normally be sufficient to justify a conclusion on the net assets test. But directors remain free, and obliged, to reach judgements appraising the financial position on a proper commercial basis while taking full account of the accounting statements. In this way both flexibility and a safe harbour can arguably be achieved. The safe harbour will by its nature have a virtuous tendency to attract directors to rely on it in cases of doubt.

But the safe harbour should only be a protection in relation to the balance sheet or net assets test; it should not provide protection for a failure to take proper care independently in relation to solvency. In this respect the proposal resembles the present English law, which requires both satisfaction of the statutory tests reflecting the Second Directive requirements and the common law.[195]

This approach to the use of the balance sheet should sufficiently answer the concern that a crude use of it might prevent legitimate distributions. The converse risk that it might allow excessive and imprudent distributions should be met by the cumulative requirement of solvency certification.

However once it is established that the net assets test is to be applied in this flexible and comprehensive way and that its satisfaction is not sufficient to justify a distribution it seems very questionable whether it really adds anything to the solvency requirement and whether the safe harbour represents a real haven at all. (This is considered below, where we conclude that it does not.)

Transferring the Burden of Proof on the General Solvency Test?

In the jurisdictions which adopt a similar approach it is widely accepted that in normal circumstances and as a matter of fact a going concern balance sheet, prepared and duly audited in accordance with current accepted accounting practice, is sufficient for directors to rely on when considering the solvency test.[196] Under New Zealand Law the directors are obliged to have regard to the balance sheet when considering that test.[197] One possibility would be to adopt a similar approach by

[195] General fiduciary duties and *Flitcroft's Case* – see above.

[196] See the guidance on the MBCA referred to in Schedule C, also recognized in New Zealand, ibid.

[197] See Annex C. Note also the requirement to have regard to contingent liabilities – correct in our view, but a matter which is understood to have caused some uncertainty in the early stages of the application of the New Zealand law, since resolved in practice.

providing that the burden of proof of fault in preparing a solvency certificate should lie on the claimant, where there is such a balance sheet justifying the distribution, but should be reversed where the directors exercise their judgement and depart from it, and make or recommend a distribution. Thus they would be required in the latter case to prove that the departure was justified.

This has some logical attractions, but in practice it might merely deter any distributions in such circumstances and it is too detailed, and too much a matter of practice and judgement for the Member States, to be included in EU law. Its merit for Britain is also a matter of judgment and would depend on wider consultation.

A similar argument might well however justify a requirement that directors, when certifying solvency in circumstances where the distribution was not justified on a going concern balance sheet basis, should state that fact and explain why they were nevertheless of the opinion that the company would remain solvent. This would in practice encourage greater care in such exceptional cases and we are inclined to favour it; it is a component of our preferred proposal, below.

Is the Additional Balance Sheet (Bare Net Assets) Test Redundant?

There is an economic argument that there is no difference between an assessment of the net asset position of a company, once the accounting figures are subjected to proper business appraisal, and an assessment of solvency. This is because the value of an asset is the discounted value of the cash which the asset is expected to realise and the value of a liability is the discounted value of the prospect of having to lay out cash to satisfy it. If so, the addition of a net assets test adds nothing, particularly if, as in New Zealand, there is a requirement to take account of the accounting information in reaching the conclusion on solvency. Alternatively, it could be argued that the requirement for a solvency certificate adds nothing to a test based on proper appraisal of the balance sheet.

This argument has some force. In practice however the net assets approach has been abandoned in very few jurisdictions, and such abandonment might prove politically unacceptable in the EU. Arguably it would leave directors with less guidance as a matter of practice than the combined approach. The converse argument, for abandonment of the general solvency requirement and reliance on the balance sheet alone, clearly has serious disadvantages in terms of the signals to directors and the dangers of undue reliance on the balance sheet, which by its nature cannot fully portray the timing and degree of certainty of future cash flows and the company's flexibility. In particular the formal requirement for a signed certificate addressing the general issue of solvency has real practical value in concentrating the minds of the board.

On balance we have concluded that the net assets test adds little and that an approach based purely on certification of solvency, broadly following the current British precedents for capital reduction, but with *supplementary disclosure* addressing the accounting net assets balance, is the best way forward for the UK. The next part of the chapter addresses the details.

Alternative Approach to Solvency – the British Precedents

It has been noted that the standard British solvency certificate approach is (in the normal case) only to require directors to certify that, in their opinion after full enquiry into the position and prospects of the company,–

(a) there will immediately after the distribution be no ground on which the company could be found[198] unable to pay its debts; and
(b) that (having regard to the intentions of management and the resources they expect to be available) the company will be able as a going concern to pay its debts as they fall due for the next year,

but the same liabilities (including the contingent and prospective ones) as are required to be taken into account by the court on an insolvent winding up must be taken into account for this purpose, or at least for (a).[199]

We understand that this provision is widely regarded as only requiring that a company should be able to satisfy its present accrued liabilities, under (a), and those debts which will fall due in the coming year, under (b).[200] The apparent extension of the liabilities to be taken into account to include "contingent" and "prospective" ones provides a less broad range of exposure than might be expected from the use of these words. A "contingent" liability means a liability which is vested (in the sense that the legal relationship exists which may give rise to an obligation to pay), but which may or may not mature into an obligation to pay, according to whether some contingency occurs (for example a liability on a guarantee agreed, or an insurance policy underwritten, by the company, or a claim on a warranty given by the company). A "prospective" liability apparently means a liability which has already accrued, or is substantially certain to do so. Examples are a liability for rent under a lease, liability under an unmatured bill of exchange, or liability for progress payments on a construction contract yet to be assessed. Apparently a company's expected liability for payments which will inevitably need to be made for the company to remain a going concern – eg next year's staff or materials costs – may well not be "prospective" liabilities and are clearly not "contingent" ones.[201]

Clearly if this, rather technical, approach to the solvency certificate, based on

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198 Query whether this means by a court, thus invoking the whole of Sec 123 Insolvency Act 1986 – see below.

199 See Sec 173(1)–(3) CA 85 (similarly, but applying the wider definition of liabilities to (a) and (b) Sec 156(2) CA 85) and White Paper, op cit, para 63 (though omitting express reference to the law on insolvent compulsory liquidation).

200 Ie under Sec 122 Insolvency Act 1986. See generally R Goode *Principles of Corporate Insolvency Law* (Sweet and Maxwell London 1997) ch 4. But cf Sec 123(2) Insolvency Act 1986 – company deemed unable to pay debts if value of assets proved to be less than amount of (sc all) liabilities, taking account of contingent and prospective ones.

201 See R Goode, op cit, 87–89. The position is made more obscure by the fact that contingent and prospective liabilities are invoked for the cash flow test applied here. Under Sec 123 Insolvency Act 1986 they are applied to the Sec 123(2) balance sheet test.

current British insolvency law, were to be adopted the extent of directors' liabilities on the certificate would be quite limited and there would be a case for an additional test in the interests of creditors to ensure that proper account is taken of the longer term prospects. There is however real value in the combination of a strict short term liquidity requirement, of the kind imposed by (b), with an indefinite assurance of viability, which must inevitably be more judgmental.

The precise nature of the solvency requirement to be applied in the UK deserves wider discussion and consultation than we have been able to conduct for the purposes of this report. The New Zealand experience is impressive, but we believe that a better balance of protection for creditors without undue exposure of directors may be achievable along the traditional British lines, with some minor development and clarification.

The Solvency Discipline – A Proposed Conclusion

So, subject to such wider consultation, we would provisionally favour a solution as follows:

– the directors should provide and publish a certificate along the lines of the first part of the present Companies Act precedent. This however currently only gives an assurance that, in their opinion, immediately after the payment there would be no grounds on which a court could find that the company was unable to pay its debts. As with the present regime, prospective and contingent liabilities should be taken into account. However the limits implicit in this extension are technical and not ones which we would expect company directors in the normal course to recognize as representing a normal commercial test of viability; we believe that the assurance should go further, beyond the contingent and prospective liabilities as defined above, to encompass the normal trading prospects of the business and the need for cash to satisfy the liabilities which will occur in consequence. This immediately gives rise to the question whether future, prospective and contingent *assets* should by parity of reasoning also be considered. Commercial realism would suggest that they should. However a measure of prudence is clearly required. The prospect of a capital increase, for example, seems obviously too contingent and remote to be permitted to count. We believe that the answer here is that the directors should be required to reach the view that *for the reasonably foreseeable future, taking account of the company's expected prospects in the ordinary course of business, it can reasonably be expected to meet its liabilities.*[202] Thus normal trading assets, including future and contingent ones, should be allowed to be taken into account, but not extraordinary transactions.[203]
– To this should be added a requirement to certify, along the lines of the second

[202] If more precision is required, the standard of reasonable expectation should be the normal one of the balance of probabilities taking the situation and prospects of the business as a whole.

[203] Sec 214(6) Insolvency Act 1986 treats the expenses of winding up as an additional accrued liability for the purpose of defining insolvent liquidation. This is clearly not appropriate here.

part of the current certificate that, having regard to their intentions and the resources in their view likely to be available, for the year immediately following the company will be able in the ordinary course of business to meet all its debts as they fall due as a going concern throughout that year. This provides a firm assurance of liquidity over what is normally the next trading cycle, based on a firm prediction of trading intentions and available resources. Here again all existing liabilities (including contingent and prospective ones) and any other liabilities which are expected to mature into obligations to pay money during the period should be included.

– We would not as a matter of logic favour an additional net assets test, for two reasons: first, once it is recognized, as in our view it must be, that such a test cannot, if it is to be of real value, be rigidly linked to the accounts, the effect of the test is, or should be, little different in substance from a view on solvency; second, such tests tend to be treated as mere mechanical applications of a calculation of balance sheet net asset value, an approach which we have shown above may lead to wrong results in either direction.
– However this does not mean that the company's accounts (taken as a whole, and not merely with exclusive focus on the two traditional statements) ought to be neglected. We therefore would propose that in making the certificate the directors should be required to take account of the company's accounts and annual report as a whole and that where the result is to declare that the company is solvent while on an application of the narrow balance sheet net assets test the result would be a deficit, they should explain why they take the favourable view. This will provide a measure of discipline.
– Civil liability on the certificate and for recipients of unlawful distributions should be based on fault. There should also be criminal liability and liability to disqualification for directors at fault, as under the present Act. The extent of the fault liability should be the normal one under the directors' duty of care, skill and diligence.[204] The standard of care will be influenced by the way in which the obligation is framed. The current certification requirement demands that the directors should certify that they have made "full enquiry into the affairs and prospects of the company".[205] An enquiry requirement is desirable, but may well be implicit; and directors should be required only to make an enquiry proper for the purpose, rather than a "full" one. A "full" enquiry will not be necessary in all cases (eg where the company has massive liquid resources and current profits which greatly exceed the proposed distribution – a by no means uncommon case).[206] It must be recognized that such an enquiry cannot be expected to provide any absolute guarantee of ongoing solvency.

[204] See now White Paper, op cit, draft clauses on directors' general duties, clause 19 and Schedule 2.

[205] Sec 173(3) CA 85; cf Sec 156(4) requiring a separate report on a similar, but not identical, enquiry.

[206] The decision how explicit to be about the directors' duty of enquiry is one of legislative policy

- The liability of shareholders should also be based on fault, as now.[207] There is a case for treating shareholders as the primary liable party, since they will have received the distribution. But this seems inappropriate; they will normally be remote from the transaction and the company and, through the company, its creditors should not be put to the trouble of pursuing often numerous and scattered shareholders.
- A mandatory auditors' certificate is inappropriate, for the reasons discussed above. However directors exercising normal standards of care will need, in large companies where there are auditors, to consult the auditors if there are doubts and the typical large company board will of course consult the finance director on the acceptability of any distribution. Moreover the audit report for the year in which a distribution takes place will need to consider the legality of any such transaction and the directors' "going concern" assurances. Thus for companies with auditors a significant audit-based and professional discipline is in practice in place, both *a priori* and *ex post*. For those smaller companies which have no auditors no such requirement is of course feasible.

  We have considered whether this approach allows for a safe harbour for directors. We have concluded that a real safe harbour is not achievable, because in the final analysis the ultimate test must be as to solvency and this does not admit of a bright line definition, even to define cases in which a distribution can safely be presumed to be prudent.

  It must however be recognized that the final calibration of this test depends on its practical effect in influencing directors, in terms of curbing undue confidence at the expense of creditors without instilling undue caution.[208] It is nevertheless notable that neither the Model Business Corporations Act, nor the New Zealand Act, nor the current far more limited British solvency certification appear to have caused any difficulty in practice.

  This suggests that for the purposes of EU law a measure of flexibility to allow the test to be adapted to Member State circumstances is necessary.

Nimble Dividend Relaxation

The above approach eliminates any need for a nimble dividend relaxation. Such dividends are only justifiable when on an overall appreciation of the business it is, in spite of a current technical deficiency of assets, solvent.

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having regard to the present Act. Consideration will need to be given to questions of the proportionality and limits of such a liability, which could be vast in relation to the fault in question, in the light of the DTI's current consultation on Directors' and Auditors' Liability, above.

207 Sec 277 CA 85, discussed above.

208 As we have indicated, a final definition should ideally be settled after thorough consultation with representatives of those concerned, particularly company directors, and careful exploration of the range of prospects to be taken into account, illustrated with practical examples.

Preference Shares

A net asset test implicitly requires the retention of assets to cover outstanding liabilities to creditors (but not on this basis the claims of ordinary shareholders). Its adoption inevitably raises the question whether preferential shareholders' rights should be treated as analogous to those of shareholders or of creditors – ie treating preferential shareholders claims as debts accruing when the claims would accrue. There is a strong case for the latter view, which is the approach adopted in the MBCA and the New Zealand legislation.[209] We would support that approach as a default rule, variable in the terms of issue of the shares or by agreement.

A pure solvency test would raise questions about the claims of preference shareholders, which may not be contractual. If the proposal to dispense with a net assets test is accepted it will be necessary to treat preferential shareholders' claims as if they were liabilities for solvency purposes.

"Class 3" Controls: Enhanced Net Assets Tests

As we have noted, many regimes, including all European public company ones, not only adopt a simple balance sheet test but build in requirements for an additional margin. They accordingly require not only at least a bare balance of net assets with liabilities, but also that the net asset balance should be sufficient to cover either share capital alone (ie the aggregate nominal or par value of all the shares in issue), or share capital plus an accumulating margin of up to 10 or 20 per cent of such capital ("legal reserve"),[210] or share capital plus all other consideration received for shares (share capital plus share premium account), or even share capital, plus share premium account, plus any amount of the legal reserve required not covered by share premium account.[211]

These rules are varied, costly and (taken together with the network of supporting rules which they carry with them) very complex.[212] The absence of any strong evidence that they are relied upon by creditors, and the arbitrary nature of the yardsticks which result, when compared with the actual commercial needs of companies for working capital, lead to the view that these rules are of insufficient value to justify the complexity and rigidity which results from them.[213] We would

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209 In New Zealand this applies both to claims for dividends and fixed capital claims. See Annex C.

210 For the detailed rules in France, Germany, Italy and Spain, see Annex C.

211 In Spain share premium apparently cannot be credited to legal reserve but is distributable – see Annex C.

212 The current British Act requires no less than 95 sections (out of a total of approximately 750) to implement the doctrine for creditor protection purposes. All but a handful of these would be redundant under our proposals.

213 Rules which require an additional legal reserve of 10 per cent, or in some States 20 per cent,

therefore recommend that, as a matter of European and UK law, any requirement for an enhancement of the simple net assets test should be abolished as a mandatory requirement. That is to say that the European law requiring a reserve for aggregate nominal value and capital redemption reserves in some circumstances, and the UK law requiring a reserve for aggregate nominal value, capital redemption reserve and share premium, should be abolished. Elsewhere in Europe it should remain a matter for Member States whether to require reserves for aggregate nominal value, capital redemption, share premium and legal reserve.

The consequence of this abolition will be that the host of detailed rules which are required to support this reserving structure can also be abolished. These include the special and onerous rules on raising of share capital, including issues at a discount, related rules about commissions and discounts, treatment of certain kinds of consideration as not valid for payment up of shares and the consequent implicit ban on true no par value shares. All of these can be repealed – a great advantage in terms of simplifying and clarifying the law and removing unnecessary burdens on company financing.

"Class 4" controls – the Earned Surplus Rule

Rules requiring that only profits "earned" by a company should be distributed duplicate in part the effect of a strict enhanced balance sheet test, since it is widely accepted that neither share capital nor share premium can be properly regarded as "earned". They also give rise to questions about what the quality of a gain or loss has to be to increase or reduce the earned surplus. In the UK this debate has manifested itself in pointless semantic arguments about what is required for a profit or loss to be "realised".[214] In European law "unrealised gains" are not allowed to be distributed, but in some circumstances and in many states, reserves corresponding to capital raised for shares are. European law thus has a partial earned surplus test, though it has been implemented in some States[215] as a full earned surplus test. It follows from our discussion of the use of balance sheet information in calculating the net assets test, above, that we regard earned surplus tests as an unnecessary additional complication.

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of aggregate par value are an additional, but minor, increase in the nominal or subscribed share capital reserve; they add complexity for the benefit of a very marginal addition, equally unrelated to any commercially quantified need of creditors, to an already arbitrary and variable protection.

214 For the relevant British law see the discussions in chs 3 and 4 on share option charges and pensions deficiencies.

215 Eg UK and Germany, where share premiums are never distributable (in the case of the UK subject to the removal of some minor technical exceptions, as proposed by the Company Law Review, above, Completing the Structure, ch 7) and there are some doubts in GB even about surpluses arising on capital reductions, now hopefully resolved by the Institutes' guidance, cited in ch 4, above.

The Optimal Distribution Regime (3) – Supplementary Rules

Wrongful Trading and "Fraudulent Transfer" Laws

We have already suggested that the solvency test should be supported by properly sanctioned general behavioural standards covering wrongful trading and non-commercial or unfair transactions in conditions of insolvency or anticipated insolvency. It has been suggested[216] that the relatively more lax US distribution regime depends in part on the availability of effective sanctions on the part of creditors, both after insolvency and, in some cases, in anticipation of their claims (even unvested claims) not being satisfied, under the Uniform Fraudulent Transfers Act and its statutory and common law antecedents.

We doubt the need to adopt such fraudulent transfer rules in the UK or more widely in Europe. The leading example of a country which has moved from the strict European approach on capital maintenance to the MBCA one is New Zealand. The evidence we have received from New Zealand is that this transition has been entirely successful. We understand that New Zealand has broadly similar rules on wrongful trading and fraudulent transfers to those in the UK.[217]

There is, in any case, a question whether the substantive effect of the US law, which at its strongest requires that a distribution may not be made unless the company would have sufficient working capital after the transfer to carry on as a going concern, is substantially different from an effective going concern solvency test. There appears to be little or no real economic difference in practice and if the US law goes further it is hard to justify. In one respect the US law is clearly more generous to creditors, allowing a remedy, including a pre-emptive injunction prohibiting a distribution, in advance of an insolvent winding up. British law is cautious about giving preferential remedies to creditors other than through the discipline of a winding up, with the getting in of assets subject to the overall control of the liquidator on behalf of the company and proper apportionment of assets amongst all competing creditors and other contributories. We support this approach.[218] We would not therefore favour going down the US route.

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[216] See M Kahan 'Legal Capital Rules and the Structure of Corporate Law' in K Hopt and E Wymeersch (eds) *Capital Markets Law and Company Law* (OUP Oxford 2002).

[217] New Zealand law has no direct equivalent of the British wrongful trading provision. Sec 135 of the Act of 1993 imposes a duty on directors not to expose the creditors to undue risk through "reckless trading". This applies in theory outside the winding up, but the duty is owed to the company. Whether the common law, *Nicholson v Permakraft*, duty (see Annex C below) survives this provision is uncertain.

[218] The origin of the US law is actually an English 16th century law – see the discussion in Annex C, Model 7 at E. The British decision not to go down the US route is a considered one.

"Sliding Scale" Liability on Threat of Insolvency

However New Zealand, and more recently English, law have gone further down the path of protecting creditors prior to insolvency. Recent cases have found a duty on company directors to have regard to the interest of creditors not only when insolvency is, or would as a result of a distribution or other transaction be, substantially unavoidable, but also when there would be a substantial threat of insolvency. This is the case law surrounding the *West Mercia* line of cases,[219] which require directors to consider the threat of insolvency at any time. Where it is significant, they are said to be bound to make greater provision to protect creditors at the expense of shareholders, the protection required varying according to the severity of the threat. The British government is still considering whether to leave this body of law in place, or to codify it, or rather to abolish it in response to prevailing business opinion, which regards it as too severe on companies in practice and likely to "chill" entrepreneurial activity.[220]

This body of law proved controversial in the UK company law review and there is no agreement in favour of its adoption or imitation in Europe. The UK government will no doubt decide soon whether to maintain it. We do not believe that the decision is material to our recommendations on distribution rules.

Postponing "Insider" Claims

The Winter group considered a further creditor protection rule, to the effect that any claim by an insider (eg a director or substantial shareholder) against the company should be postponed to those of the general body of creditors.[221] Such provision would be a significant disincentive to insider loan financing and a major interference with vested rights. We would not support it in the British context.[222]

Optimal Regime – Other Specific Capital Maintenance Aspects

We therefore recommend as the core of a capital maintenance regime –

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[219] *West Mercia Safetywear (in liq) v Dodd* (1988) BCC 30 (CA UK), following *Nicholson v Permakraft NZ (in liq)* (1985)1 NZLR 242, (1985) ACLC 453 (HC NZ). See Annex C.

[220] See the discussion in Company Law Review, Final Report, above, at 3.12 and ff and the White Paper, I, 3.8 and ff. The UK Government does not seem to have reached a final view on the *West Mercia* principle. It may well be content to leave the matter to be developed by case law.

[221] Winter Report, op cit, 86.

[222] The use of subordination as a remedy in cases of wrongful trading is not open to these objections however, see Sec 215(4) Insolvency Act 1986. Compare the US doctrine of equitable subordination see R Clark 'The Duties of the Corporate Debtor' [1977] 90 Harvard Law Review 505 and *Taylor v Standard Gas* 306 US 307 (1939). See too Secs 240 and 245 Insolvency Act 1986 (preferences, undervalue transactions and floating charges with insiders).

(a) a solvency test based on a robust going concern certification requirement, combined with

(b) an obligation to take account of the company's financial statements as a whole for this purpose, and where the distribution is not covered by balance sheet net assets to state that fact and justify it.

In the UK the only real substantive additional obligation will be to require a formalised compliance, through the directors' certification, with the already existing common law obligation to secure that the company's solvency is not imprudently hazarded. The supplementary balance sheet test is the same, except that it will be relaxed (or tightened) to ensure that a proper prudent appraisal of the commercial balance of assets and liabilities is relied upon and that it becomes a strong disclosure requirement rather than a substantive limit. This requirement will cut both ways. Directors will need to consider whether the statutory balance sheet net asset balance overstates, or understates, the true commercial position.[223] The most important relaxation will be the removal of the present arbitrary reserving requirements for nominal values and share premium.

It follows from this recommendation that major simplifications and efficiencies in the capital regime can be achieved. Because there will be no need for special capital reserves, subscribed capital as a mandatory requirement will disappear and therefore no special rules on publicity for capital will be needed, nor for minimum capital, nor, so far as creditors are concerned, about the quality of capital on raising.[224] The proposed rule on distributions should apply to all forms of distributions including capital reductions and share buy-backs, which will, to the extent they remain as transactions, be indistinguishable from distributions. However as we made clear in chapter 2 this should leave in place the special shareholder and minority protection rules which apply to capital transactions, eg for special resolutions authorizing share buy-backs and authorization rules for share issues, including the overriding of mandatory pre-emption rules, which apply where shares are issued for cash.

The special risks to shareholders, creditors and wider investors from market abuse through, for example, inappropriate share buy-backs and financial assistance transactions should be addressed by properly focused and targeted securities regulation, as already recommended by the Winter Group, and above in chapter 2. The special rules on financial assistance as part of company law, which are impossible to justify in principle, and quixotically and arbitrarily applied in practice, should be abolished as part of company law.

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[223] Off balance sheet items, including contingent liabilities, will require particularly careful attention. This requirement is explicit in the New Zealand Act – see Annex C. We understand that it caused some doubt and uncertainty in the early stages, but has now settled down in practice.

[224] These rules, including valuations of non-cash consideration for shares, are also intended to protect members from dilution. This is discussed separately below.

Member/Minority Protection and Dilution

These simplifications follow from the removal of the capital reserving requirements; the complex rules to be abolished are no longer necessary for creditor protection. However the question arises whether anything of value would be lost from the perspective of member, and particularly minority, protection. As has been explained, the member protections provided through member control of capital transactions are to remain intact; however the substantive provisions on capital raising, notably the valuation requirements for non-cash payment up of shares, are intended to protect members from dilution.

In chapter 2, it was argued at greater length that these rules are not justifiable as proportionate responses to this concern. They are costly, inconvenient and cause delay. They are also ineffective, either in substance (as in the case of the no issue at a discount rule), or in that they are relatively easy to avoid (as in the case of valuation rules). The risks addressed arise, perhaps more acutely, in other contexts and require a more general response within the company governance system. In the UK this is provided by transparency rules,[225] member governance powers and minority remedies, all operating to sanction the overall fiduciary duties of boards to act in the best interests of members as a whole, in the issue of shares as in all other operational activities. Finally, as a matter of experience in the UK, the other responses in the company governance system have been shown to be sufficiently effective to deal with the problem; there was no call for such rules for public companies before the Second Directive implementation in 1980, and no call for them for private companies, before or since. The abolition of the rules on capital raising will therefore be clearly and wholly advantageous for the UK. The position may be different for the civil law countries in the rest of the EU, however. The necessary response at EU level is discussed below.

The Wider Context – A European Framework

None of this is to suggest that companies should not be free to adopt whatever rules they decide are appropriate to their circumstances in excess of this minimum for the establishment of non-distributable or restricted reserves. This should continue to be possible both internally, through rules in company constitutions and articles, and externally, by contract. Similarly, Member States should be free to insist on a stricter regime for their own companies within Europe. We do however believe that a solvency-based regime is likely not only to be simpler and less costly than the current arrangements but also to be more effective in protecting creditors. It should also prove a clearer and more rational basis for harmonization of conditions in the

[225] Notably Sec 88 CA 85, which provides strict rules, in the case of any allotment of shares paid up otherwise than in cash, for disclosing at the companies registry the relevant contracts in writing and the consideration given.

European capital markets. Thus, while we agree with the Winter Group proposals that Member States should generally speaking remain free to retain the old Second Directive style regime where they wish to do so, we believe that there is a strong case for requiring solvency certification as a minimum in all Member States. (We propose below, consistently with this approach, that the somewhat liberalized regime for British public companies, which we favour if there is to be no change in EU law, should also include a solvency certification requirement.)

We argued above that nothing would be lost in the UK in terms of member protection and anti-dilution policy, and much gained, by removal of the rules on capital raising, but that the position in the rest of the EU might be different. In civil law States where the fiduciary duty system and minority remedies are apparently less well developed and the governance powers of the general meeting over the board are more limited and less entrenched, there is probably a need for Member States to compensate for the loss of the rules on capital raising by the provision of an explicit duty to achieve fair value for the benefit of the members as a whole. This was suggested by the Winter group; in their opinion a general obligation to raise fair value would "substantially improve the protection of shareholders as compared to the current legal capital regime".[226] Such an EU rule would in our view already be implemented in the UK.

There should also be a general EU requirement imposing a "wrongful trading" standard, as proposed above.

We recognize too the arguments in favour of the retention of a "stated capital" regime (ie the maintenance of the existing non-distributable reserve for subscribed capital and, in some countries, legal reserve and share premium account) in existing companies as a transitional measure. We consider this further in the next part of this chapter, which examines the scope for a more effective regime to be adopted in the UK within the existing constraints of the Second Directive and makes proposals for exploiting that scope to improve British law without change at the EU level.

It is convenient in that context also to discuss whether and to what extent the concept of "par value" survives under these proposals.

Part III: Liberalising UK Law within EU Constraints

Three areas have already been noted above where UK law adopts capital maintenance rules which are more restrictive than those required by EU law:

- the regime for private companies, to which none of the Second Directive regime applies,

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[226] Winter Report, op cit, 88, 89. The Group suggested, inter alia, (93) as a possibility that all issues not exempt from valuation should be subjected to member authorization in stead. This for large companies would be even more costly and inconvenient than valuation.

and two areas where there is room for relaxation of the Second Directive regime as it has been applied to public companies in the UK: the rules on –

- share premiums and
- capital reductions.

Private Companies

The immediate and obvious question is whether and to what extent it is possible and desirable to adopt the optimal regime, as proposed above for all companies, for British private companies. There are three possible constraints: EU law, the transitional effects, and the effect of the requirement to keep in place the community regime for public companies, with possible resulting "knock-on" effects in practice on private companies.

Private Companies and EU Law

The Second Directive applies only to public companies. The only EU company law rules about capital which apply to private limited companies are thus the rules about disclosure in the First and Fourth Directives,[227] and the special rules requiring a non-distributable reserve covering the net balance of profits arising from revaluations in the Fourth Directive.[228]

Disclosure

The disclosure provisions do not appear to impose a substantive constraint. While they presuppose the subscribed capital regime as it operated throughout the community for private companies at the time of the Second Directive, their objective is disclosure. They cannot impose a substantive requirement that all companies should maintain a subscribed capital.[229] Their spirit and purpose can be met by requiring companies which have a subscribed, or stated, capital to disclose that capital, while requiring those which do not have such capital to state what their capital arrangements are. Thus where they are to state the amount of the subscribed capital, private companies capitalized entirely by no par value shares with no non-distributable reserves should be required to state the fact that they have no nominal capital, but are capitalized by no par value shares, stating their number in an appropriate case, eg as a note to the balance sheet.

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[227] Arts 2(e), 4 First Directive; Arts 9, 10 Fourth Directive.

[228] Art 33(2)(c),(d) Fourth Directive. See too the discussion of the directive on taxation of international mergers below.

[229] Note that the First Directive applies to guarantee companies which have no share capital, Art 1 First Directive.

Fourth Directive

The Fourth Directive provision is apparently more troublesome. It is anomalous in that, in a Directive about disclosure, which applies to both public and private limited companies, it purports to impose a constraint on distribution. Yet this fits within an overall distribution regime under the Second Directive, which applies only to public companies. This restriction on private companies thus appears as an isolated reserving requirement with no supporting body of distribution rules at EU level.[230]

The relevant provision of Article 33 requires that, where valuations by other than the historic method are adopted, the resulting differences should be credited or debited to a special "revaluation reserve" which can only be reduced by capitalization or by a change in circumstances which leads to the reserve no longer being necessary (no doubt typically as a result of a further change in values). However, if the reserve may be capitalized, then, since there is no constraint in community law on the terms in which it may subsequently be reduced in the case of private companies, we believe that it is reasonable to approach the Directive constraint for private companies as allowing a capitalization and reduction of the reserve, including by distribution, subject to the same rules as we propose for reductions under the optimal approach.[231] The alternative view – that the Fourth Directive requires private companies to maintain an undistributable reserve for unrealized profits, thus imposing an earned surplus distribution regime on all private companies throughout the community – seems to us a far-fetched interpretation of the Directive, unlikely to be upheld by the Court, having regard to the Directive's scope. For this view to operate it would have to prevent private companies from reducing revaluation reserve by capitalization and reduction of capital. This would be inconsistent with the explicit provisions of the Fourth Directive (which allows capitalization and does not, of course prevent reduction of the resulting capital) and would have the paradoxical effect of imposing a more stringent regime on distribution of private companies' unrealised profits than public ones'. The latter are evidently permitted to capitalize revaluation reserve and then reduce it, in accordance with the provisions for capital reduction allowed in the Second Directive.[232]

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230 Note that in the preamble to the Fourth Directive, 2nd whereas, the Council recites that the companies in question "offer no safeguards to third parties beyond the amounts of their net assets".

231 The writing down of a capital reserve – ie "reduction of capital" – in such a regime does not of course involve any real cancellation of shares; because they have no par values a proportionate reduction of shares has no substantive effect.

232 The Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States of 23 July 1990, [1990] OJ L 225 applies to public and private companies, including guarantee companies. It limits the cash consideration to be included in an eligible share for share merger to a maximum of 10 per cent of the aggregate par value of the acquiring company's shares issued in consideration for the merger, Art 2. It thus assumes (already wrongly in the case of guarantee companies) that the acquiring company has a par value share capital. This is evidently erroneous and it is an optional provision, applying only to acquiring companies. It was clearly not intended to limit the capital

Accordingly, while it might be argued that Community law requires a strict earned surplus test for private companies, we do not accept this view. It is accordingly open to the UK to adopt the optimal regime proposed above for all private companies, ie a solvency certification requirement for distributions.[233]

Such a regime could provide substantial alleviation of the rigid capital regime under the Second Directive for public companies also, because it would allow public holding companies trading through private company subsidiaries to achieve profits in those subsidiaries on a modern basis and then to distribute them to the holding company as realised profits. Pension funds could also be operated by private company subsidiaries, with appropriate intra-group funding from associated companies.

Transition and the Public Company Interface

The Company Law Review proposals on private company capital reductions (to be allowed with solvency certification), own share purchases (to be allowed out of capital with solvency certification) and the financial assistance prohibition (to be abolished), already anticipate this recommendation in substantial respects. However the CLR took the view that it would not be wise to adopt a full mandatory no par value capital regime for private companies, for two reasons. First, there might be major transitional difficulties, because of existing legal commitments related to the nominal value capital structures. Second, it would complicate the law excessively to retain par values for public companies while abolishing them for private ones, creating in particular a need for capital restructuring at the time of conversion from private to public – a process which should, it is agreed, be made as easy as possible.

However we believe that there are major advantages to be achieved from relaxing the distribution rules in the way proposed for private companies. In the light of the comparative material we also believe that no par value shares can be introduced, while enabling new and existing companies to retain the relevant features of par

structure of private companies. The Commission has issued a Proposal for a Council Directive amending Directive 90/434/EEC, which goes further in scope of 17 Oct 2003, COM(2003) 613 final <http://europa.eu.int/eur-lex/en/com/pdf/2003/com2003_0613en01.pdf>. The opportunity should be taken to amend the cash balance provisions, here and in the Third and Sixth Directives, to substitute a maximum proportion, possibly 10 per cent, of the total consideration for the merger, so as to make the directives effective for guarantee companies and those with NPV shares. A limit by reference to par values is arbitrary and disproportionate, see ch 2. The cash balance requirements anyway seem avoidable by an appropriate cash transfer between the merging companies in advance of the merger to align an all share exchange ratio, but this may have tax consequences.

233 Even if the view were taken that an Art 15(1)(c) Second Directive earned surplus test is required by EU law for private companies the other components of our optimal solution could be readily combined with this (including distributability of share capital and share premiums, but not of course unrealized profits). But unrealized profits could still presumably be capitalized and the resulting capital reduced subject to solvency certification!

value share capital where they need to do so, and requiring that existing companies only remove them subject to appropriate safeguards, thus avoiding the transitional difficulties and complexity which the CLR anticipated. The result will be the disappearance of mandatory par values, though many of the related rules will remain either to be adopted as a matter of choice, or, in the case of existing companies, in the shape of the continued mandatory retention of a stated capital corresponding to the aggregate of existing par values (as well as share premium account and capital redemption reserve) and requirements as to the conditions subject to which this stated capital can be written down (with or without distribution) with consequent removal of par values. This is explained in greater detail below.

(The result of our proposals will however be very much in line with the Company Law Review, "Think Small First", approach to the deregulation of private companies. There would, as with the CLR proposals on governance, and particularly company decision making, be a simple, minimalist approach to capital applicable to new companies as a default regime on registration. This could be made more elaborate and sophisticated by agreement or through the articles. Similarly, special transitional provisions are required for existing companies.)

Transition

First, it should be possible for existing and new private companies when issuing shares to adopt in their articles or in the terms of issue of their shares, a "stated capital" reserve which is to be undistributable, as permitted in Delaware. There can be no objection to such freedom. The terms on which such a reserve may be reduced should also be a matter of contract, though the capital reduction regime, including the requirement for a special resolution, should perhaps apply as a default regime in the sense that if no provision is made contractually with shareholders for reduction the current rules for shareholder control of reductions should apply. If the reduction would lead to a distribution the distribution rules for the protection of creditors should similarly apply. Where, whether for existing or new companies, any reduction of capital involves a distribution to shareholders that should, of course, attract the new distribution rules.

Second, in the case of existing companies' issued capital, current par values, capital redemption reserves and share premium account should be treated as stated capital, but capable of reduction by capital reduction under the new rules, and subject to the normal internal safeguards (ie special resolutions and class meetings where currently required). Where contractual commitments prevent such reduction the protected status of these reserves should remain, subject, of course, to renegotiation of the contractual terms.

We see no reason why this approach should create any greater difficulty than it does in other jurisdictions, such as Delaware or Ontario, where no par value shares are combined with a stated capital regime.

Private/Public Company Conversion – The Interface

An analogous approach can be taken to the problems which arise where private companies are converted to public. All shares must, as a result of the Second Directive, have par values attributed to them on the re-registration; this need have no substantive effect other than to create an undistributable reserve of subscribed capital apportioned amongst each of the shares. This can be done quite simply, by companies adopting at the time of re-registration an appropriate "subscribed capital" at whatever level is regarded as convenient, subject only to the trivial minimum capital requirement of the Directive. Existing commitments relating to stated capital reserves, whether in the articles or in contracts, would remain unchanged, though they might be subsumed in the new subscribed capital, on such re-registration. We would not regard it as necessary or appropriate at the same time to require the creation of any share premium account (other than any reserve of that kind already maintained); that would involve a historical investigation of the consideration received over time for shares issued and would not be required either by the Directive or by any arguments based on the reasonable expectations of members or third parties. We in any case doubt whether it is appropriate to require public companies to have undistributable share premium accounts, but that is a matter of public company regulation, to which we turn in the final paragraphs of this chapter.

Nominal or Par Values – Do They Survive?

We raised the question earlier whether par values survive under the proposed optimal regime, whether it is to apply to all companies or only to private ones. This becomes a matter of semantics. Some aspects of the legal rules attaching to par values will survive, either as transitional or as autonomous requirements. Others disappear completely. Par values do not survive in the sense that it will no longer be the case that all shares are currently required to be denominated by a par value. The "no issue at a discount rule" will not survive and there will therefore be no mandatory requirement in general law (restrictions in contracts or the articles are another matter) that every share should have a par value for that purpose. Similarly there will be no mandatory requirement that an amount of capital, identified by reference to the par value of each share, should be carried to a share capital reserve, so there will be no requirement for par values for that purpose. If therefore those default rules are adopted there will be nothing corresponding to par values and every share will, as a default matter, be a true no par value share.

However, we have suggested that for existing companies the transitional requirement should be that they retain a stated capital in respect of their current issued shares, equivalent to existing par values, plus share premium account, plus capital redemption reserve, but with liberty to reduce it by reduction of capital. We have also suggested that where their existing contractual commitments require the retention of such reserves, or the indicia of a particular par value attaching to their shares for reference purposes (eg to establish relative priorities), they should remain bound to do so, subject to renegotiating the contracts. In one respect however we would not keep in place the existing regime even for existing companies – we see no case for maintaining the no issue at a discount rule, except in the unlikely event that a company chose to adopt such a rule by contract.

Finally, for all companies, it should be possible to adopt any lawful commitment to maintain reserves, adjust rights, or constrain the issue of shares. Such commitments may produce the same legal results as are achieved at present by par values.

In short, under the "optimal" regime proposed, all shares will have a residual character as no par value shares, but this will not affect any obligations of existing companies, subject to their right to adjust those obligations in accordance with the normal conditions (including complete elimination of par values/subscribed capital) and to their freedom to issue shares at a discount.

In practice we would expect that in time all shares would become recognized as true NPV shares, with any special incidents attaching to them being treated as contractual, or provisions of the company's articles.

Public Companies (Reform Within EU Constraints)

It was established in chapter 2 that EU law does not require share premiums to be carried to an undistributable reserve and the law of some EU States fails to require this. The main reason (apparently) for adoption of such a rule in the UK was the recognition in 1947[234] that to require only par values to be undistributable produced arbitrary results, given the freedom of issuers to set par at any amount and the naturally declining component of par values in share values over time.

However the evidence on the value attributed in practice to share capital in this sense as a security to creditors, taken with the rigidity of the constraint, indicates that this argument, while logical, is founded on false premises. There is a strong case, if the optimal approach cannot be adopted for public companies, for at least reducing the rigidities of the EU regime to the legitimate minimum. We would therefore recommend that the existing requirements for share premium account should be abolished, subject to the same transitional regime as that proposed for the capital reserves of private companies in the preceding part of this chapter. This should, of course, be subject also to the continuing right of public companies to adopt additional undistributable reserves by contract or in their articles.

For similar reasons, we would recommend that the EU provision allowing share capital to be reduced without a distribution, where to do so is required to write off losses, should be adopted as part of our law for both private and public companies. This would be a change of some substance for British law, as it would remove a

[234] Cohen Committee, 1945, Cmd 6659, para 108, which however contains no analysis or reasoning.

court control. However the control is light in such cases.[235]

The effect of the first of these proposals will in due course for many British public companies be very substantial. Since nominal values are typically a minor part of the capital reserves (for historic reasons already explained), and an even smaller proportion of the consideration on new issues, the effect, over time, will be to reduce undistributable capital reserves to a relatively small proportion of their existing amount. The result will be much closer to the optimal solution proposed above, but with the very important difference that the present unsatisfactory mechanical connection between accounts and calculation of distributable reserves will be preserved. The existing duty on directors to act prudently having regard to solvency will remain, but there is a clear and strong case for requiring the formal solvency certificate in this context also, to emphasize and bring home to directors the importance of the solvency requirement in the new liberalised circumstances.

Summary

This chapter has proposed reform of capital maintenance in the UK and Europe, or failing that, at least in the UK within limits permitted by the existing EU law.

Our concern has been with the creditor protection aspects. The internal governance aspects of the current regime do not present pressing difficulties, and should remain unchanged.

The objective is to achieve a fair, proportionate and efficient balance of interests where assets are returned to shareholders, between the shareholder's right to receive a proper return and the creditor's right to be paid. Such a balance is in the interests of all the stakeholders.

The focus should be on maintaining a reasonable expectation of solvency. This indicates a formal obligation on directors when making or recommending distributions to provide a certification of solvency on a going concern basis, with effective sanctions attaching to its preparation and use. We favour certification of a continuing ability to pay debts and of going concern liquidity over the coming year, with all existing and expected liabilities being brought into account. There should be an obligation when preparing the certificate to have regard to the company's financial statements and the other relevant parts of the annual report and where the balance sheet does not show sufficient net assets there should be an obligation to state why the board believes nevertheless that the solvency tests are satisfied. But a firm view on the details of this certification would require a wider consultation.

Enhanced net assets balance sheet tests requiring special or capital reserves should not be generally required. The outcome for net earned surplus tests, which have a similar effect, should be the same. But companies should be allowed to

[235] See Sec 136 CA 85 – the special protections in (3)–(5) will not apply. The shareholder protections would again remain in place; indeed in this case they would be required by Arts 30, 31 Second Directive.

opt for such special capital reserves, and existing companies should be required to maintain them for currently issued capital until reduced by capital reductions. Such capital reductions should also be permitted on a solvency basis and subject to appropriate internal governance provisions. Shares would lose their par values, but the main effect of this in substance on mandatory law would be abolition of the no-issue-at-a-discount rule.

This regime, supplemented with duties to achieve fair value on capital raising, should be an option for Member States for public companies throughout the EU. But Member States should also be free to retain the existing Second Directive regime.

Consideration should however be given to requiring solvency certification in addition to the present regime where the option to retain it is exercised. There is a strong case for this. The High Level Group proposal of a wrongful trading prohibition throughout the EU should also in any event be adopted.

The new proposed regime for distributions renders redundant the special creditor protection rules on publicity for subscribed capital, capital raising and consideration for shares, capital reductions and buy-backs and, in our view, this is an opportunity to abolish the financial assistance prohibition.

If such a new regime for the EU is not negotiable within a reasonable time, then

– the same regime should be adopted in the UK for private companies, including the subsidiaries of public companies; and
– the present rules for public companies on non-distributable share premium account and creditor protections on capital reductions without distributions to write off losses, should be relaxed to the maximum extent allowed by EU law; but
– solvency certification should be required, for all distributions, formalizing the existing common law rules requiring prudence in distributions.

Annex A: Members of the Interdisciplinary Group

Professor Jonathan Rickford (Chairman)	Director, Company Law Centre, British Institute of International and Comparative Law
Sir Bryan Carsberg	Formerly Secretary General, International Accounting Standards Committee
Professor Paul Davies	London School of Economics and Political Sciences
Michael Edbury	Department of Trade and Industry, London
Clive Edrupt	Confederation of British Industry, London
Mary Keegan	Chairman, Accounting Standards Board, London
Vanessa Knapp	Chair, Law Society Company Law Committee, London
David Lawton	Her Majesty's Treasury, London

Annex A. Cont.

Andrew Lennard	Technical Director, Accounting Standards Board
Professor Dan Prentice	Pembroke College, Oxford
Andrew Watchman	Department of Trade and Industry, London
Malcolm Woodford	Chairman, Institute of Chartered Accountants in England and Wales – Company Law Committee, Formerly Partner, PricewaterhouseCoopers

Note: Members of the group participated in a personal and not a representative capacity. Members from the UK government service did so as observers.

Annex B: Others assisting in the work of the Interdisciplinary Group

M Andenas	BIICL
S Bryan	Department of Trade and Industry, London
R Burns	Department of Trade and Industry, London
Professor B Cheffins	Cambridge University
D Chesworth	Financial Services Authority, London
Professor J Coates	Harvard Law School
L Correia	Oxera, Oxford
Professor Julian Franks	London Business School
M Garcia-Riestra	BIICL
Professor R Grantham	Auckland University
Professor J Hanks	Bucerius Law School, Hamburg; Venable LLP, Baltimore
Professor B Hannigan	Southampton University
G Holgate	Allen and Overy, London
S Kuck	BIICL
K McGuinness	Hamilton-Wentworth Legal Services, Ontario, Canada
Professor M Menjucq	University of Paris I
E Monaci	BIICL
M Noakes	HM Treasury, London
M Pannier	BIICL
Professor M Ross	Formerly, Associate Professor, Unitec Business School, Auckland, New Zealand

Annex C: Comparative Conspectus of Capital Maintenance

Purpose and Approach

This Annex describes the models of Capital Maintenance systems, and legal techniques which substitute[236] for such systems, in eleven of the main advanced jurisdictions for corporate law.

The essence of traditional capital maintenance is to treat consideration received for shares as wholly or partly a fund which should, for creditors' benefit, be protected from reduction by any return of assets to shareholders. Associated with this are two further concerns: first, that any such returns, whether reducing that fund or not, and any reallocation of assets on a capital increase, should be equitable as between shareholders; and possibly second, at least in some jurisdictions, concern that capital attributed to shareholders should remain returnable to them in a winding up.

Most jurisdictions without capital maintenance regimes, strictly so called, in the sense that they do not require maintenance of such a fund, do however enforce specific rules to prevent excessive returns of assets to shareholders, whether by distributions, repurchases of shares or reductions leading to the return of assets. All, so far as we are aware, have rules for protecting shareholders from inequitable capital transactions; but these rules often form part of the general system of member protection through company governance mechanisms.

Typology

The concerns thus addressed arise in **5 main areas**, which are useful for comparing systems, to which it is convenient to add a residual category:

A: payment up of shares, or capital raising, ("Payment") (including rules about proper valuation of consideration and minimum payment, both per share and in total)

B: distribution of assets in the form of distributions to shareholders generally (typically cash dividends, but sometimes dividends in kind and sometimes other forms of distribution which do not appear to be dividends) ("Distributions")

C: reductions of the capital fund by a write down, whether in conjunction with a return of assets to shareholders or not ("Reductions") (A reduction which is not accompanied by a return of assets to shareholders does not appear to fit in a

[236] This expression begs some key questions of a kind which are crucial in a comparative exercise of this kind. This is because in all systems many of the purposes of capital maintenance – assuring solvency and securing fair treatment of shareholders in relation to distributions and analogous transactions – are achieved also by other means. In those of the systems considered below which arguably have no recognizable capital maintenance regime, it is the case that they once had one and it is possible to identify as a historic fact what has replaced it.

discussion of capital maintenance; however even when there is no immediate return of assets, the effect of the reduction is to allow such a return in future in circumstances where, but for the reduction, such a return would not have been possible)

D: Purchases or redemptions of its own shares by the company ("Repurchases").

In many contexts B, C, and D may all be described as "distributions"; this is useful in stressing that the policies should be consistent, but the considerations in these different contexts are not identical and rules do differ (coherently or not).

E: Further Aspects. Ie ancillary points and comments – eg financial assistance; board and general meeting authorities in relation to capital transactions.

The Importance of Context

However there is an important qualification, or rider, to this typology. Rules identified as within the areas of capital maintenance (including distribution rules) identified above and the rules closely related to them form an integral part of the wider systems of law in which they are embedded. Other parts of these systems will contribute to meeting objectives targeted by capital maintenance in the strict sense.

For example, in Britain, fiduciary duties of loyalty, care and skill impose obligations to apply business assets prudently, including in distributions, and to obtain fair consideration for share issues, on behalf of members as a whole. This is modified in favour of creditor protection, when there is a threat to the company's solvency, the degree of this depending on the severity of the threat. The best known such rule is the wrongful trading obligation.[237] Similarly, insolvency law sanctions fraudulent trading, undervalue and preferential transactions.[238] These creditor remedies arise in insolvency once claims have failed; but the obligations will relate back to the imprudent transaction. Distributions will be amongst the transactions caught. So the law sets important standards for corporate behaviour where insolvency (and thus danger to creditors) is possible in the context of a distribution.

There are similar provisions in the laws of many European States. The Winter Group proposed that a wrongful trading standard should be adopted throughout the EU.[239] One of their reasons was that such a standard would support the allegedly more liberal solvency based distribution regime which they recommended for serious study.

The US Uniform Fraudulent Transfer Act, adopted in various forms in many states' laws and in Federal bankruptcy law, is a stronger version of this phenomenon,

[237] Sec 214 Insolvency Act 1986 (See too *West Mercia Safetywear (in liq.) v Dodd* [1988] BCLC 250 CA).

[238] Secs 238-243 Insolvency Act 1986.

[239] Winter Report, op cit, 68–69.

deriving from the same historical origin. The regime allows creditors, even if their claims have not yet matured, to pursue debtors, including companies, which engage in transactions at an undervalue or for no consideration (including distributions), where the result is to leave the company with an insufficiency of assets.[240]

When proposing reforms of company law by reference to comparative evidence in the particular area it is important to consider the wider contextual balance of this kind. If not, apparent equivalences of protection will mislead.[241]

We now consider, as model regimes designed to meet the concerns identified above, the main jurisdictions examined for the purposes of this Report:

1) EU – Second Directive;
2) UK;
3) Germany;
4) France;
5) Italy;
6) Spain;
7) US – Model Business Corporations Act;
8) Delaware;
9) California;
10) Canada; and
11) New Zealand

by reference to these five areas.

1), the EU, is of course the basis (set as a minimum) of the EU jurisdictions 2) to 6); however it is useful to examine the differing ways in which EU law has been implemented in these jurisdictions, considering the stricter approach of the UK (and Ireland which is very similar) and Germany, on the one hand, and the rather more relaxed regimes (in some respects) of France, Italy and Spain, on the other.

7) to 9) give an indication of the range of US solutions (though we have omitted Massachusetts, which relies solely on a solvency test for distributions and is therefore arguably representative of an even more liberal and simple approach).

10) and 11) exemplify laws deriving from strict British capital maintenance traditions, but which have adopted a strong American flavour, less so in Canada, very close to the MBCA in New Zealand. Since the British approach is very close in detail and philosophy to the general approach in the EU, Canadian and New Zealand

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240 Uniform Fraudulent Transfer Act, National Conference of Commissioners on Uniform State Laws, July 1984, Chicago, 1984; see especially Sec 4(a)(2)(i) – "A transfer .. is fraudulent ..if made..without receiving reasonably equivalent value.. and debtor was engaged in business for which the remaining assets of the debtor were unreasonably small". This law is English in origin, deriving from the 16th and 17th centuries and adopted by the US states on their foundation – see the discussion under 7), US Model Business Corporations Act, below.

241 See M Kahan 'Legal Capital Rules and the Structure of Corporate Law' in K Hopt and E Wymeersch (eds) *Capital Markets Law and Company Law* (OUP Oxford 2002).

experience is of particular interest, showing change in traditional European type environments towards the more modern US approach.

Model 1 – Second Company Law Directive

The provisions of the Second Directive are restricted to public limited companies or similar forms in other Member States.[242]

This scope rule has often been criticised because the use of the different company forms is divergent between the Member States.[243] Furthermore, the protection of creditors of private limited companies, especially newly founded companies, can be regarded as even more important.[244]

Most of the provisions of the Directive can be regarded as minimum standards; Member States are free to impose stricter ones in favour of the interests protected.[245]

A. Payment

Article 6 (1) of the Directive requires not less than 25,000 euros subscribed capital. Under Article 7 the subscribed capital has to be composed of assets capable of economic assessment, excluding undertakings to perform work or services.

Articles 9 and 26 require not less than 25 per cent payment up of nominal value.[246] On a narrow interpretation of Article 9(1) and Article 26(2) a premium has only to be fully paid up on an increase in capital and need not be on first payment. But Articles 10 and 27 require an expert's report on provision of all non-cash consideration (par value and premiums).[247] Under Article 11, a similar valuation and shareholder approval must be assured for certain post incorporation transactions with promoters. Article 9(2) requires non-cash executory consideration to be

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242 Parallel forms of public and private limited companies in the UK, Germany, France, Italy and Spain:

UK	public limited company	private limited company
Germany	Aktiengesellschaft	Gesellschaft mit beschränkter Haftung
France	société anonyme	société à responsabilité limitée
Italy	società per azioni	società a responsibilità limitata
Spain	sociedad anónima	sociedad de responsabilidad limitada

243 E Wymeersch 'A Status Report on Corporate Governance Rules and Practices in Some Continental European States' in K Hopt and others (eds) *Comparative Corporate Governance – State of the Art and Emerging Research* (OUP Oxford 1998) 1045, 1049.

244 S Grundmann *Europäisches Gesellschaftsrecht* (C F Müller Heidelberg 2003) para 351.

245 See for the discussion: V Edwards *EC Company Law* (OUP Oxford 1999) 55; Case C-42/95 *Siemens Nold* [1996] ECR I-6017, 6034–6036.

246 Or accountable par (ie a fixed proportion of issued capital) treated as equivalent to par – a Belgian concept. See E Ferran *Company Law and Corporate Finance* (OUP Oxford 1999) 286.

247 Any attempt at explanation on the basis that the directive assumes that there will be no premiums on first issue is of course met by the valuation requirement.

executed within five years. Article 8 prohibits issues at a discount to nominal value. This excludes true no par value shares, as do the various disclosure requirements, eg Article 3 (b), demanding the amount of nominal values to be disclosed.

B. Distributions

Art 15(1) of the Directive imposes as a minimum rule a two-fold test for direct distributions:[248]

(i) a balance sheet test in Article 15(1)(a) – ie prohibiting a distribution which reduces the assets below the amount of the "subscribed capital" and any reserves which may not legally be distributed. These are to be identified by reference to the last annual accounts; and

(ii) an accumulated running account profits test in Article 15(1)(c), limiting distributions profits for the latest financial year plus profits brought forward, together with "sums drawn from reserves available for the purpose", less sums carried to reserves and accumulated losses.

It is evident that distributions must satisfy both hurdles. Special provision is made for interim distributions by reference to interim accounts – Article 15.2. Article 16 requires any distribution made contrary to Article 15 to be returned by the recipient if the company proves that he knew of its irregularity or could not in view of the circumstances have been unaware of it.

Article 31(1)(c) of the Fourth Directive[249] provides that "valuation must be made on a prudent basis, and in particular:

(aa) only profits made (French "benefices realisés") at the balance sheet date may be included, and

(bb) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year…".

Article 33 of that Directive allows Member States to provide for valuation on the replacement value basis for certain tangible fixed assets, or by methods designed to take account of inflation, and for revaluations of tangible and financial fixed assets, rather than on the basis of purchase price or production cost. Differences arising are to be carried to a revaluation reserve. No part of this reserve may be distributed unless it represents gains actually realized. It may only be reduced by capitalization or when it is "no longer necessary" (which will come about when an unrealized or revaluation profit or loss is realized (at which point it is carried to profit and loss account), or adjusted or eliminated on a further revaluation).

[248] A distribution includes in particular payment of dividends and interest on shares, Art 15(1)(d).

[249] Fourth Directive.

C. Repurchases

Article 18 of the Second Directive generally prohibits a company from subscribing for its own shares. Articles 19-21 and 39 deal with exemptions. Typically acquisitions require general meeting authority and redemptions and withdrawals require quite precise authority in the articles and original terms of issue. So far as the effect on the balance sheet is concerned, if the repurchased shares are cancelled there must either be a substitute capital reserve established for the capital repurchased or there must be creditor protection equivalent to that required for a reduction of capital.[250]

Article 19 of the Directive requires general meeting authorization of repurchase of shares, except to prevent serious and imminent harm.[251] The maximum duration of the authority is 18 months, the maximum aggregate nominal value of the shares is 10 per cent of subscribed capital and there must be a satisfaction of the net asset distribution rule. The acquisitions may therefore not have the effect of reducing net assets below the amount of the "subscribed capital" and any undistributable reserves. Article 19(1)(c) only imposes the Article 15(1)(a) balance sheet test; it does not also impose the Article 15(1)(c) accumulated running account profits test.

The law of the Member States can provide that own shares may or are to be included among the assets shown in the balance sheet. In this case an additional undistributable reserve of the same amount has to be included among the liabilities, Article 22(1)(b).

D. Reductions

Articles 30 and 40 of the Directive require a general meeting decision by qualified majority for a reduction of capital. Article 32 provides for creditor protection, with a minimum of a right to apply to the court where they do not have "adequate safeguards" for claims which have not fallen due by the date of publication of the decision. Article 33, remarkably, provides that where a reduction is made to write off losses no creditor protection is required. This seems clearly at variance with the general philosophy, as set out above.[252] According to Article 34 the subscribed capital may not be reduced to less than the amount of the minimum capital.

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[250] Arts 20(3), 36(1)(d), 37(2) Second Directive.

[251] The Member States may however exclude from this treatment certain transactions, eg concluded by banks and other financial institutions in certain circumstances, Art 20 Second Directive.

[252] A point remarked upon by the Winter Group, Winter Report, op cit, 91, but not mentioned and therefore apparently not to be followed up in the Commission Action Plan.

[253] Under Art 23(2) and (3) Second Directive this prohibition does not apply to transactions concluded by banks and other financial institutions in the normal course of business, nor to transactions effected with a view to the acquisition of shares by or for the company's employees or the employees of an associate company and to transactions effected with a view to acquisition of fully paid up shares issued by an investment company with fixed capital.

[254] See the discussion in Ch 2, above, and E Wymeersch 'Art 23 of the Second Company Law Directive' in J Basedow and others (eds) *Festschrift für Ulrich Drobnig* (Hamburg 1999); but compare V Edwards *EC Company Law* (Clarendon Press Oxford 1999) 73.

E. Further Aspects

Article 23 of the Directive prohibits, subject to specified exceptions,[253] a company from advancing funds, making loans or providing security, with a view to the acquisition of its shares by a third party. The purpose of this provision is not clear.[254]

Capital increases must be authorized by the general meeting, with special provision to protect preemption rights on increases in equity for cash, but directors may be given a shareholder mandate to issue shares for up to five years without further reference to the general meeting. If this overrides preemption rights a special resolution is required.[255]

The Winter Group, following and extending the SLIM proposals, suggested some modifications to the Directive.[256] Key issues are (i) introduction of (real) no par value shares; (ii) relaxation of valuation requirements for contributions in kind (Article 10) in certain cases; and (iii) more flexible requirements at least for unlisted companies for the acquisition of own shares (eg acquisition of own shares should be allowed within the limits of the distributable reserves, and not of the current arbitrary 10 per cent limit). The Commission took up these recommendations in its action plan of May 2003.[257] For further discussion see chapter 2, above.

Note

Models 2 to 6, listed below, are European models required to comply with this Directive. The account therefore concentrates on aspects peculiar to particular Member States.

Model 2 – UK

A. Payment

Under Sections 117, 118 Companies Act 1985, a public limited company must have a minimum capital of £50,000. In spite of Article 9(1) of the Directive, Section 101(1), Companies Act 1985 requires payment in full of any premium, on first issue or subsequently.

B. Distributions

Companies Act 1985, Part VIII tries to make sense of the rules on distributions by

(i) setting distributions to be justified by reference to the last annual accounts or interim accounts – Sections 270 and ff.
(ii) providing that for all companies, profits available for distribution are the accumulated realized profits, so far as not previously utilised by distribution or capitalization, less the accumulated realized losses so far as not written off in a reduction or reorganisation of capital – Section 263 (3); and

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255 Arts 25, 29 Second Directive.
256 See Winter Report, op cit, 78–93.
257 Action Plan 2003, op cit.

(iii) providing for public companies – Section 264, that a distribution may not be greater than the excess of its net assets over the amount of its share capital and undistributable reserves (ie its share premium account, capital redemption reserve and a reserve of the excess of its accumulated uncapitalized unrealized profits over its accumulated unrealized losses not written off by a capital reduction or reorganisation); and

(iv) providing that "realized profits" and "realized losses" are to be treated as realized "in accordance with principles generally accepted at the time when the accounts are prepared, with respect to the determination for accounting purposes of realized profits or losses", Section 262 (3).

The Companies Act 1985 also makes elaborate rules for treating share premiums as subscribed capital by requiring an undistributable reserve subject to the same rules as share capital – "share premium account", Section 130 (1) and (3). Under Section 130 (2) share premium account may be applied in paying up unissued shares to be allotted to members as fully paid bonus shares or in writing off the company's preliminary expenses, or the expenses of any issue of shares or debentures of the company, or redemption premiums on debentures. The Company Law Review, following the Jenkins Committee, took the view that the last 2 exceptions which corresponded to normal operational expenditure, were not justifiable and should be abolished.[258]

C. Repurchases

Sections 159, 162, 171 Companies Act 1985 deal with repurchase/redemption, implementing the relevant provisions of the Directive. Buy backs may be made out of distributable profits or the proceeds of a new issue of shares. According to Section 170 Companies Act 1985 a capital redemption reserve has to be set up to make good the reduction in capital resulting from the transaction which requires, normally, the cancellation of the shares bought back.[259] This reserve is to be treated as if it were share capital with the exception that it may be used to pay up fully-paid bonus shares.[260] The requirement to make a transfer to the capital redemption reserve applies only to the extent that the buy back is funded from distributable profits. Where the proceeds of a fresh issue are used the new issue is treated as substituting for the existing share capital.[261]

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[258] Jenkins Committee, Cmd 1749, para 163; CLR, Company Formation and Capital Maintenance, op cit, para 3.21, CLR, Final Report, op cit, para 7.

[259] Buy-backs without cancellation have recently been introduced – the necessary further provision is made by Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003 (SI2003/1116) effective from 1 Dec 2003.

[260] E Ferran *Company Law and Corporate Finance* (OUP Oxford 1999) 444.

[261] Note that if the UK was to abandon the strict treatment of share premiums as capital, as proposed in ch 5, detailed amendments would be required to ensure that the par value of the new issue was increased by an undistributable reserve if it did not match the par value of the shares repurchased.

These rules apply with some variations to both public and private companies. In particular private companies may repurchase shares out of capital subject to a solvency declaration, (Sections 171 to 173 Companies Act 1985).

D. Reductions

Section 135 CA1985 provides for reduction of capital by special resolution, subject to court approval. The CLR proposed an alternative option of the most relaxed version of the Second Directive regime without court approval, but not to allow writing off of losses without creditor protection.[262] However, the CLR proposed that the option instead of court approval should require solvency certification by the directors. Due to the need to comply with the provisions of the Directive for public companies the right of creditors to challenge the reduction in court would be preserved.[263] Whether there should be audit of the certificate and what the standard of liability of the directors should be was hotly debated, but the conclusion was that there should be no audit requirement and that liability to reimburse wrongful distributions should be based on fault. This proposal amounts to distribution to shareholders of capital based on solvency certification permitted under the Directive.

E. Further Aspects

Financial Assistance

Under Section 151 CA1985, financial assistance by a company for the acquisition of its own shares is generally prohibited. Ss 153-158 CA85 provide for the possible exceptions. According to Section 153 (1) CA85 financial assistance is not prohibited if (a) the company's principal purpose in giving that assistance is not to give it for the purpose of any such acquisition, or the giving of the assistance for that purpose is but an incidental part of some larger purpose and (b) the assistance is given in good faith in the interest of the company. Section 153 (2) CA1985 makes equivalent provisions for assistance given after the acquisition.[264] Section 153 (3) provides for other situations where the payment of money for the purpose of assisting a share acquisition will not be within Section 151 CA85; the list is not exhaustive.[265] Section 153 (4) (a) and (b) admit financial assistance where the lending of money is part of the ordinary business of the company and for employee share schemes. Section 155 provides for relaxations for private companies.

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[262] CLR, Completing the Structure, op cit, para 7; CLR, Final Report, op cit, para 10; White Paper, op cit, II, 6.5.

[263] However, this right would not apply in respect of private companies. Private companies would according to the proposals, have a simple and certain method for reducing capital where such a reduction does not jeopardise the solvency of the company. However the White Paper reopened this question see White Paper, op cit, 72.

[264] See for the implementation of Art 23 Second Directive in the United Kingdom and the discussion on s 153 (2): Edwards *EC Company Law* (Clarendon Press Oxford 1999) 73 ff.

[265] M Arden and D Prentice *Buckley on the Companies Act* (Butterworths London 2000) [153.15].

Authorities for Capital Transactions

In addition to the Directive requirements, the institutions apply best practice limits on the size of authorities for issues of equity by directors and exemptions from pre-emption.

The Company Law Review (CLR) proposed significant relaxations for private companies, in particular to reinstate the general default rule that share capital increases are a matter for the board.[266] It also recommended that the provisions of the Companies Act on financial assistance for the acquisition of own shares should no longer apply to private companies because they are arbitrary and costly in their effect.

On 17 July 2002 the DTI published the White Paper "Modernising Company Law" and took up many of the Company Law Review proposals especially in respect of capital maintenance rules of private limited companies, which will be simplified in the future as the draft clauses already reflect. They include for instance the abolition of the requirement to have an "authorized share capital"; the introduction of a solvency statement by the directors as an alternative to the present requirement for the court's approval for a capital reduction; the removal of the prohibition on the giving by private companies of financial assistance for the acquisition of own shares; and revision of the distribution rules to clarify what is a "distribution".[267]

Model 3 – Germany

A. Payment

According to Article 7 Aktiengesetz, (Stock Corporation Act 1965 "AktG") the minimum capital for an Aktiengesellschaft (AG) (public company) is 50,000 euros. Shares can be par value shares or since 1998 fractional no par value shares, Article 8(1) AktG.[268] Article 9(1) contains the prohibition on issue of shares at below par ie below the proportionate amount of the subscribed capital.

Under Article 36a (1) AktG cash considerations have to be paid up only as to at least 25 per cent of their minimum issue value. Although not required by Article 9 (1) of the Second Directive, an original issue premium has to be paid up in full in the same way as a premium on an increase of capital. In accordance with the Directive non cash-considerations must be paid up in full within five years, Article 36a (2).

B. Distributions

The restrictions on distributions to shareholders are in Article 57(1) and (3) AktG which implement Article 15 of the Directive and entail a test which goes beyond the two-fold test required by the Directive. Article 57(3) permits only the distribution

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266 CLR, Final Report, op cit, paras 2.30 and 4.4.

267 White Paper, op cit, II, 6.5.

268 In the latter case each share represents a part of the subscribed capital, not of the whole capital of the company. See already the description for the Second Directive (Model 6 A).

of the previous financial years' net profits (Bilanzgewinn). Article 57(1) prohibits every other distribution and every evasion like "hidden" profit distributions (eg certain shareholder loans, transactions with affiliates). German law does not explicitly prohibit a distribution which reduces the assets below the amount of the "subscribed capital" (balance sheet test, cf Article 15.1[a] of the Directive). Nevertheless, such a prohibition is implicit. Generally, legal reserves cannot be distributed. Therefore, distributable net profits are the amount of the accumulated profits of the balance sheet and cannot reduce the amount of the subscribed capital. The German implementation act did not change the provisions of Articles 57 and 58 AktG.[269]

Additionally, German law in Article 150(2) AktG requires a legal reserve (profit reserve) of five per cent of the last financial year's net profits less any losses brought forward to be set up, until all legal reserves together (including a capital reserve required under Article 272(2) of the Commercial Code (HGB) reach 10 per cent of the subscribed capital, or a higher percentage if so prescribed by the articles. Such reserve is not distributable since it is not part of "balance sheet profit" under Article 57(3). It is treated as part of the share capital on the liability side of the balance sheet, Articles 266 and 272 HGB.

According to Articles 150(3) AktG and 272(2) HGB share premiums (Agio) are treated as contributing to the legal reserve. They can only be applied in line with Article 150(3) and (4) AktG to set off the current or previous years' losses, where not covered by profits, or by capitalization. Even if the legal reserve under Article 150 (2) AktG and capital reserve under Article 272 HGB have been sufficiently set up and is equal to or exceeds 10 per cent of subscribed capital share premiums can only be used to compensate a year's net loss, a net loss brought forward from prior years or to fund an increase in capital from the company's own resources, Article 150 (4) AktG.

In Germany therefore, like Britain and Ireland, share premium account is not distributable.

Under Article 62(1) AktG any distribution made contrary to Article 57 AktG has to be returned by the shareholder if he knew or was negligently unaware of its irregularity.

C. Repurchase

In accordance with the Second Directive the repurchase of own shares is generally prohibited. Article 71 AktG provides for the possible exceptions and the further requirements and limitations for these cases. According to Article 272 (4) HGB (Commercial Code) a legal reserve has to be established on the liability side of the balance sheet corresponding to the amount of the entry for own shares on the asset side. For that reason treatment of own shares as an asset cannot lead to a distribution of capital.

[269] U Hüffer 'Harmonisierung des aktienrechtlichen Kapitalschutzes' [1979] Neue Juristische Wochenschrift 1065.

According to Article 71a (2) every legal transaction between the company and a third party according to which the third person is entitled or bound to buy shares on the company's or an operating company's behalf is void if this purchase performed by the company would be contrary to Article 71 AktG. Article 71d AktG prohibits every purchase or holding of shares by a third party if it acts on behalf of the company and the purchase or holding would not be allowed for the company itself. Under Article 71e AktG a pledge of the company's own shares to the company is treated as an acquisition. In accordance with Article 24 (2) of the Directive banks or financial institutions are excluded from this prohibition if the transaction was concluded in the normal course of business.

D. Reduction

There are three forms of reduction in capital. The "ordinary" reduction in Articles 222–228 AktG requires a three quarter majority at general meeting and certain provisions for creditor protection have to be satisfied. The "simplified" reduction of capital in Articles 229–236 AktG is permitted for re-establishment of sound conditions (ie to balance losses). Profits resulting from such a reduction cannot be distributed to the shareholder. On the other hand, creditor protection is not necessary nor some other formalities. Thus German law takes advantage of the Second Directive, Article 23 exception for accumulated losses. Reduction through redemption of shares in Articles 237-239 AktG is only possible if it is permitted by the articles and is subject to the normal rules on reduction under Article 237(1).

E. Further Aspects

Articles 71a, d and e AktG implement Article 23 and 24 of the Directive (financial assistance). Article 71a(1) declares void every legal transaction by the company which provides an advance, loan or security for the purpose of acquiring of the company's shares by a third party. Article 71a(1) provides for the exceptions for financial institutions and for company's employees or the employees of an associate company.

Recently, the German Stock Corporation Act was amended by the KonTraG;[270] the NaStraG[271] and the TransPuG[272] which all had the purpose of making the German Stock Corporation Act more competitive and increasing transparency in respect of capital markets. Also the provisions relating to capital maintenance were amended. For instance the prohibition of a company from subscribing for its own shares was relaxed. Now own shares can be subscribed for "price nursing" (ie smoothing of

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[270] Gesetz zur Kontrolle und Transparenz im Unternehmensbereich of 6.3.1998, BGBl I 1998, 786.

[271] Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung (Namensaktiengesetz) of 18 Jan 2001, BGBl I 2001, 123.

[272] Transparenz- und Publizitätsgesetz of 17 May 2002 (BGBl I 2002, 2681).

the market price, stabilization) by decision of the general meeting, Article 7(1), 8th sentence, AktG.

Especially after the *Centros, Ueberseering* and *Inspire Art* decisions of the ECJ the capital maintenance rules for the Gesellschaft mit beschränkter Haftung (GmbH) (private company) are under discussion.[273] In response to the report of the Winter Group the German Government stated (with reservations) that the conventional capital maintenance system for German private limited companies could be replaced by an alternative solvency test system in the future.[274]

Model 4 – France

A. Payment

For public companies a minimum capital is required of 225,000 euros (formerly 1,500,000 FF), Article L 224-2 Code de Commerce (CC). At least 50 per cent of the par value needs to be paid at the time of subscription; the balance between the paid-up portion and the par value must be settled within five years, Article 225-3 CC. Issue premiums need only be paid in full immediately in the case of an increase in capital, Article L 225-144 (1) CC. Contributions in kind must be contributed in full, Article L 225-3 CC. A minimum par value is not required, but real no par value shares are not allowed, Article L 228-9 CC.

B. Distribution

In accordance with the Directive the French law provides a two-fold test for direct distributions including a current account profits test in Article L 232-11(1) CC and a net asset balance sheet test in Article L 232-11(3) CC.

In the course of the corporation's operation, five per cent of the distributable income of the SA must be allocated each year to a special legal reserve account (compte de réserve légale) until this account amounts to 10 per cent of the subscribed capital, Article. L 232-10 CC.

Dividends can be paid either in cash or in kind (including shares of the company if provided for in the statutes and authorized by general meeting).

It is not entirely certain whether share premiums can be distributed. There is no express prohibition of this however. Nor is there any requirement that share premiums should be credited to legal reserve.[275]

C. Repurchase

In accordance with the Directive, Article L 225-206 CC prohibits a company from subscribing its own shares, directly or by a person acting on behalf of the company.

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[273] R Kulms 'Die US-amerikanische Limited Liability Company – Vorbild für die GmbH?' [2003] 102 Zeitschrift für vergleichende Rechtswissenschaft 272.

[274] Bundesministerium der Justiz, June 2002, question 17 http://www.rws-verlag.de/volltext-2002/02lutter3.htm

[275] See P le Cannu *Droit des Societes* (Montchrestien 2003) para 1107.

The exceptions are in L 225-207 to 217 CC. The company must finance the purchase out of surplus assets and must have reserves, other than the statutory reserve, amounting to at least the value of all its own shares held, L 225-210.

D. Reduction

In line with the Directive capital reductions must be authorized by a special shareholder meeting, Article L 225-204 CC. An auditors' report on the proposed operation must be delivered to the shareholders of the company within a period to be fixed by an order approved by the Conseil d'Etat. Where the meeting approves a capital reduction proposed for reasons other than losses, the representative of all bond holders and creditors may raise an objection, Article L 225-205 CC. The amount of the share capital can be reduced below the statutory minimum only if the corporation is transformed into a company of another form, or if the capital is increased above the statutory minimum immediately afterwards.

E. Further Aspects

The implementation of Article 23 of the Directive is in Article L 225-216 CC. A company shall not advance funds, grant loans or provide a pledge of security for the subscription or purchase of its own shares by a third party.

The provisions are not applicable to ordinary transactions by credit institutions, nor to operations carried out to enable employees of the company, one of its subsidiaries or a company included in a group savings scheme, as provided for by Article L.444-3 of the Employment Code, to purchase shares in the company.

In 2000 French company law was reformed. The provisions of Loi no 66-537 du juillet 1966 sur les societes commerciales were integrated into the Nouveau Code de Commerce without changing the law itself.[276] Under the law of 15.5.2001 the French provisions for the société à responsabilité limitée (SARL) (private company) were comprehensively changed.[277] One of the changes is that only twenty per cent of the subscribed capital has to be paid up within the first five years.[278] Perhaps most significantly for our purposes, after 2004 the minimum capital of the SARL (currently 7,500 Euros) will be abolished on the ground that minimum capital performs no useful function and constitutes a hurdle to business activity.[279]

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[276] Ordonnance Nr 2000-912, Journal Officiel (JO) 21 Sept 2000, 14783 (correction JO 18 Nov 2000).

[277] Loi no 2001-420 of 15 May 2001 relative aux nouvelles regulations economiques, JO n 113 of 16 May 2001, 7776.

[278] S Frank and T Wachter 'Neuere Entwicklungen im französichen GmbH-Recht' [2002] Recht der Internationalen Wirtschaft 10.

[279] Loi pour l'initiative économique, Loi n° 2003-721 du 1er août 2003, (LIE) of 21 July 2003 coming into force on 1 Jan 2004. Art 1 LIE will abolish Art L 223-2 Code de Commerce. <http://www.legifrance.gouv.fr/WAspad/Visu?cid=24587&indice=1&table=CONSOLIDE&ligneDeb=1>.

Model 5 – Italy

A. Payment

Under Article 2327 Codice Civile (CC) the minimum capital of the Societa per azioni (SpA – public company) is 120,000 euros. In line with the Second Directive, at least 25 per cent of the minimum issue value for cash-considerations and 100 per cent for non-cash considerations have to be paid up, Article 2342 CC. The shares have proportionate or accountable par value, rather than nominal value, Article 2346 CC.

B. Distribution

The Italian SpA has to comply with both tests required in Article 15 of the Directive, an account profits test in Article 2433(2) CC and a net asset balance sheet test in Article 2433(3) CC.

A legal reserve of at least five per cent of the annual net profit is to be set up ("riserva legale"), until the aggregate reaches 20 per cent of subscribed capital, Article 2430 CC.

Share premiums (Sovraprezzi delle azioni) can only be distributed if the legal reserve which has to be set up under Article 2430 CC is fully paid up, Article 2431 CC.

Under Article 2433(4) CC any distribution made contrary to 2433(2) and (3) CC has to be returned if the shareholder knew or was negligently unaware of its irregularity.

C. Repurchase

In accordance with the Directive the acquisition of own shares by the company is generally prohibited, Article 2357 CC. Articles 2357 et seq CC provide for the possible exceptions and the further requirements and limitations for these cases.[280]

D. Reduction

In line with the Directive, Italian law requires a decision of the general meeting by qualified majority for a reduction of capital, Article 2445 CC. The authority of the general meeting is only valid for three months and creditors have a right to apply to the court, Article 2445 CC. A capital reduction is required if there has been a loss of more than one third of the subscribed capital, and if the loss is not recovered, at least as to one third, by the end of the following year, Article 2446 CC.

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[280] According to Art 2357 CC, the company can repurchase own shares, only if : 1) the money comes from either available capital reserve or distributable profits not paid to shareholders, 2) the shares are completely paid up; and 3) the total amount of own shares is not more than 10 per cent of capital. According to Art 2357 seq, CC, there are some exceptions to the general prohibition of the acquisition of own shares: 1) if the shareholder's meeting decides a capital reduction, which has to be made by repurchase of own shares; 2) if the repurchase is "gratuitous"; 3) if the company acquires through an inheritance, merger, or company division (scission); 4) if the company acquires to recover a debt due.

E. Further Aspects
The company cannot give financial assistance for the acquisition and the subscription of its own shares: it can give neither loans nor guarantees. However, the company can give financial assistance to its employees who acquire its shares, in order to facilitate that acquisition, (Art 2358 CC).

Decreto Legislativo 17 gennaio 2003, n 6 has recently modified the articles of Codice Civile, concerning public and private companies. The new legislation will be in force from 1 January 2004. The summary above takes account of these changes as if they were already in force.[281]

Model 6 – Spain

A. Payment
According to Article 4 of the Ley de Sociedades Anónimas of 27 December 1989 (Public Companies Act, LSA) the minimum capital required for public companies shall be 60,101 euros (formerly 10 million pesetas). Capital must be fully subscribed and at least 25 percent of the nominal value of each share paid up (Article 12 LSA).

Shares cannot be issued at less than their nominal value (Article 47(2) LSA). Shares may be issued at a premium but any premium will have to be entirely paid up on subscription, Article 47.3, whether on a first issue or an increase of capital. Share premiums form a distributable reserve (ie separate from the legal reserve).

Cash considerations must be paid in euros and the deposit certificate issued by the credit institution shall be presented before the Notary, Article 40 LSA.

With regard to non-cash consideration, independent experts appointed by the Registro Mercantil (Companies House) must prepare a report indicating the valuation methods used and indicate if the result obtained is equivalent to the aggregate, nominal value, of the shares and any premiums.

If the shares are partially or totally paid up with non-cash consideration, or cash which is not to be transferred immediately, the following aspects must also be determined before the Notary, Article 40 LSA:

> The value of any non-cash and whether any future payments will be in cash or non-cash.
>
> In the latter case the value, nature, content and the procedure and time frame of payment, which must not exceed five years after the incorporation, shall be determined.

[281] One of the main goals of this reform is to facilitate the provision of capital. Companies may now form "patrimoni separati" (separate capital funds) to finance a particular business; limits to bond issuing are less strict. The distinction between the SpA and the Societa a responsibilita limitata (SRL) (private company) is also increased, with many simplifications for the SRL, including the structure of the company. The reform brought many changes for capital maintenance, but the SRL still must have a minimum capital of 10,000 Euros. See M Buse 'Reform des Italienischen Gesellschaftsrechts' [2002] Recht der Internationalen Wirtschaft 676.

B. Distributions

Pursuant to Article 213 LSA, the company can only distribute its profits and the distributable reserves (including share premiums), once the statutory and legal provisions (ie legal reserve and other requirements) have been complied with, and if the value of the net assets is not, and does not in consequence become, less than the capital. If losses from previous years have made the value of the net assets less than the capital, profits must be used to make good the losses.

In any event, 10 per cent of the annual profit shall be allocated to the legal reserve until the latter reaches at least 20 per cent of the capital. Until this limit is reached, the legal reserve can only be used to cover losses if no other reserves are available for this purpose.

Distributions can be paid in cash or in kind. In the case of cash the general meeting must decide on the distribution. Conversely, distributions in kind can be agreed by the general meeting or the board if the following conditions are complied with (Article 216 LSA):

> The directors must prepare an accounting report demonstrating that the company has sufficient liquid funds to carry out the distribution.
>
> The amount of the distribution must not exceed the profits earned in the last year reduced by the losses incurred in the previous years, plus the prescribed amount to be included on the legal reserve and other statutory reserves (ie determined by the statutes), and an estimate of the tax to be levied on the profits.

Share premiums are not eligible to pay up the legal reserve as they form a separate distributable reserve.[282]

C. Repurchases

In any event the company will not be allowed to subscribe its own shares nor those issued by its holding company, Article 74(1) LSA. If this provision is breached a legal presumption is established that the subscribed shares will be the property of the subscribing company. The obligation of paying up such shares on a first issue will be imposed upon the founding shareholders or in the case of capital increase, the directors.

The company may acquire its own shares once issued or those already issued by its holding company if the conditions and limits laid out by Article 75 LSA are complied with. However Article 77 LSA also provides some cases where the abovementioned limits do not apply.[283]

If the provisions of Articles 74 and 75 LSA are infringed, the shares shall be sold within a maximum time frame of one year. If this is not done the shares shall

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[282] See F Vicent Chulía *Introducción al Derecho Mercantil* (14th edn Tirant lo Blanch Valencia 2001) 278–281.

[283] Art 77 LSA is drafted in similar terms to Art 20 Second Directive.

be immediately written off and the capital reduced and there is also the possibility of imposing administrative penalties.[284]

D. Reduction

The decision to reduce the company's capital has to be passed by a special shareholders majority (as for amendment of the statutes), Article 164 LSA and published according to the formalities laid out by Article 165 LSA and Articles 170-172 of the Companies House Regulation (*Reglamento del Registro Mercantil*). The decision taken by the shareholders' meeting must indicate at least the minimum information prescribed by Article 164(2) LSA.[285]

If the reduction involves a repayment of capital which does not apply equally to all shares, the decision must be taken in accordance with the formalities provided for amendment of the statutes and class rights.[286]

If the purpose of the reduction is reestablishment of the balance between liabilities and assets reduced as a consequence of the losses, it shall apply in an equivalent manner to all shares in proportion to par value, respecting any special class rights.

In cases of effective reduction of capital the creditors of the company are entitled to oppose the decision in the conditions prescribed by Articles 166-167 LSA.[287] However where the reduction is solely to write off losses there is no such creditor right – thus Spain takes advantage of Article 33 of the Second Directive.

Pursuant to Article 168 LSA, capital cannot be reduced to write off losses, nor to constitute or increase the legal reserve if the company has provision requiring statutory reserves or if the legal reserve amounts to more than 10 per cent of the capital once the reduction has taken place. Accordingly, in the case of losses the statutory reserves and then the legal reserve (if it amounts to more than 10 per cent) should be used first instead of reducing the capital.

Moreover, the excess of assets over liabilities resulting from the reduction must be allocated to the legal reserve, provided that the latter does not exceed 10 per cent of the new capital and after a reduction, the company will not be able to make distributions until the legal reserve reaches 10 per cent of the new capital.

Reduction and simultaneous increase of the capital (accordion operation): This transaction is authorized if the decision includes the transformation of the company or capital is increased to be equivalent or superior to the minimum. Moreover, the

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[284] These would be imposed by the Comisión Nacional del Mercado de Valores (CNMV), see Art 89 LSA.

[285] Size of reduction, purpose, procedure, time frame and amount to be paid by the shareholders.

[286] See Arts 144 and 148 LSA.

[287] This opposition would not apply in cases of: – reestablishment of a balance between the liabilities and the assets, reduced as a consequence of the losses (ie to compensate losses); – when the purpose of the reduction is to constitute or increase the legal reserve and when the reduction is drawn from the profits or the distributable reserves or the amortization of shares donated to the company. In this case the par value of the amortized shares or the reduction of the par value of the shares will form a reserve which can only be distributed if the requirements for capital reduction are complied with.

conditions laid out by Article 169 LSA (eg preference acquisition right) shall be complied with before the operation is carried out.

Reduction of capital by acquiring own shares. The LSA distinguishes between:

- Donation (*título gratuito)*: The amount of the par value of the amortized share or the reduction of the par value shall be allocated to a reserve which can only be distributed if the requirements applicable to reduction are complied with.[288]
- Own shares acquired for cancellation, Article 170 LSA: An offer shall be made to all shareholders and published in the Official Journal including the necessary details to provide accurate information to shareholders.

E. Further Aspects

Under Article 81 LSA the company shall not advance funds, grant loans, provide security or facilitate any other kind of financial assistance for the acquisition of its own shares or the shares of its holding company by a third party. This prohibition does not apply to transactions carried out by employees of the company to acquire its own or holding company shares, nor to ordinary transactions carried out by banks or credit institutions that are guaranteed with unsecured assets (*bienes libres de la sociedad*).[289] In this case the company must create a reserve equivalent to the credits.

Recent company law reforms in Spain have only dealt with corporate governance issues and take-overs. No proposals to review the current capital rules have been discussed.

Model 7: US Model Business Corporations Act[290] *– Cumulative Equity Insolvency and "Flexible" Balance sheet tests*

A. Payment

The Model Business Corporations Act (MBCA) appears to make no special provision about payment up of shares.

Because shares have no nominal value there is no "no issue at a discount" rule. Nor apparently is there any rule about whether shares may be partly paid, or by how much. There are no minimum capital rules.

The normal fiduciary rules, which require proper and careful use of directors'

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288 Art 167 LSA. See R Uría *Derecho Mercantil* (28th edn Marcial Pons Madrid 2002) 386.

289 "Transactions made by banks or other credit entities within their ordinary scope of business when backed by the unencumbered assets of the corporation" Spanish Corporation Law Limited liability company law (Series of Legislation in translation, Kluwer Law 1996) 109–110.

290 This is a model law propounded by the American Bar Association. While not law it is of great authority and followed in many respects by many states. See Model Business Corporations Act, Rev 1999, American Bar Foundation xix.

powers for the benefit of the corporation would of course apply to the raising of capital.[291]

B. Distributions

Section 6.40 requires satisfaction of both of the following tests:

(a) an "equity insolvency" test – ie the corporation must be and remain after the distribution "able to pay its debts as they become due in the usual course of business"; and
(b) a "net asset", or "balance sheet", test – ie the corporation's assets must not be, nor become as a result of the distribution, less than "the sum of its total liabilities" plus (subject to the articles, which may exclude this requirement) the sums necessary to satisfy any preferential rights in a winding up (in British terms).[292]

The board, which, subject to the articles, has authority to authorize the corporation to make distributions, may reach its conclusions on these two tests either on the basis of:

(i) "financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances" or
(ii) "a fair valuation or other method that is reasonable in the circumstances".

The commentary on the MBCA says that:

(a) in normal circumstance the "equity insolvency" test can be readily satisfied by reference to accounts audited as of a going concern. It is reasonable to assume in normal circumstances that the corporation will continue to generate funds and that short-term indebtedness will be refinanced. Contingent liabilities should be assessed on the basis of the likelihood, timing and amount of any accrual. A cash flow analysis may be required; and
(b) that the assessment of assets and liabilities is a matter for the directors' judgment. They are "entitled" to rely on accounting statements in compliance with US GAAP, and GAAP are presumed reasonable. But a fair value or appraisal method of valuation is expressly permitted. However selective revaluation is normally not permissible.[293]

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[291] MBCA Sec 8.30 and see commentary on Sec 6.21. These duties of course also apply to the making of distributions.

[292] MBCA Sec 6.40(c).

[293] The balance sheet or net worth test was apparently controversial, some participants in finalising the MBCA maintaining that it demands too much subjective judgment by the board. Massachusetts relies solely on the "equity" test – see Manning and Hanks at 184–186.

This appears to allow distributions where the effect of accounting standards is to create charges to the profit and loss account and/or liabilities in the balance sheet which nominally exceed the surplus, but are arguably to be valued at a lesser amount.

C. Reductions

Because under MBCA shares have no nominal (or par) value and there is no "stated capital" (as to which see below) equivalent to aggregate nominal value, there can be no fund, or undistributable reserves for share capital, to reduce. So the problems of capital reduction do not arise. A company which reduces its assets below the amount which would have constituted the share capital liability in a nominal value or stated capital regime will simply have to satisfy the distribution tests, if this is the result of the transfer of assets to shareholders in their capacity as such.

D. Repurchases

For similar reasons, in the case of share buy-backs there is no basis for reconstituting a reserve equivalent to share capital on repurchase of shares in order to maintain the capital yardstick, as required in Europe in most circumstances; the same rules as for distributions (with some minor changes to deal with timing of satisfying the tests)[294] can be applied to determine how much of the assets should be returned to shareholders for the surrender of their shares. (Because repurchases of shares involve the surrender of the relevant shareholder's claims on the corporation, selective purchases will not necessarily disadvantage other shareholders, as would selective dividends. However repurchases on too generous terms will do so, by diluting the rights of the existing shareholders (returning to repurchased shareholders more than the value of their claims on the corporation). The elaborate rules to prevent this in the British regime are covered for the MBCA by the general fiduciary duty).[295]

E. Further Aspects: Directors' Liability

Directors' liability is covered in MBCA Section 8.33. This imposes personal liability on any director who assents to a distribution infringing s 6.40, or the articles, to the extent of the illegality, or who complies with those requirements but breaches Section 8.30 (fiduciary duties). Shareholders knowingly in receipt of such dividends are liable to contribute, as are fellow directors at fault.

Fraudulent Transfers

Note that, in all the US states considered here, directors and others are bound by the law on fraudulent transfers as well as by the fiduciary duties. This law, which originates in an English statute of Elizabeth I in the late sixteenth century,[296] varies from

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294 MBCA Sec 6.40(e).

295 MBCA Sec 8.30.

296 The first statute was in 1571, but the key case is probably *Twyne's case* in 1601 3Coke 80b,76

US state to state, though it is part of the law of all of them in one form or another and is also part of Federal Bankruptcy law. The main regimes are however based on the Uniform Fraudulent Transfer Act.[297] The key features of this for our purposes are first, that a creditor may have a remedy for a fraudulent transfer whether or not the company is in liquidation and whether or not his claim has matured[298] and second, that any distribution (as per se a transaction without reasonable consideration)[299] will be treated as giving rise to such a remedy whenever the distribution leaves the company insolvent or with assets which are "unreasonably small" for its business. The equivalent British provisions, though deriving from the same legislative and case law origins, are more restrictive in that creditors only have a remedy in a winding up and while they allow transactions to be attacked not only where there was no reasonable prospect of continuing solvency at the time,[300] but also where transactions were entered into to prefer creditors or at an undervalue[301] the period of "relation back" in these latter cases is shorter than the normal limitation period in the US.[302] British law also retains the general Fraudulent Transfer liability which is enforceable outside a winding up and in an appropriate case against a third party. However this requires not only a transfer at an undervalue but also an intent to put assets beyond the reach of a claimant, or a similar intent.[303]

Model 8: Delaware – Optional Par Values and Stated Capital, Net Assets Test, "Nimble" Dividends Relaxation

A. Payment

Delaware corporations may issue stock with or without par value ("PV").[304] Consideration for the issue of shares can be in any form and its value is a matter for bona fide business judgement of the directors.[305] But the value of the consideration for shares with PV must be not less than that value.[306] The board may decide what part

ER 809 (Star Chamber), extending fraudulent conveyance to include cases where there were "badges of fraud" – ie fraud was to be inferred from the circumstances. See Baird and Jackson [1985] 38 Vanderbilt Law Review 829. See too the discussion in ch 5. The main effect in practice may be to impose a discipline on third parties funding a distribution who are at risk from creditors, in theory at any time, but most probably in a winding up.

297 1984, above, and its predecessors as adopted by the US National Conference of Commissioners on Uniform State Laws. See <www.fraudulenttransfers.com>.

298 *American Surety Co. v Connor* (1929) 251 NY 1, 166 NE 783, 67 ALR 244 (Cardozo CJ).

299 *US v Gleneagles Investment* (1983) 565 Fed. Supp. 556 (DC Penn, Muir J).

300 Sec 214 Insolvency Act 1986.

301 Secs 238–243 Insolvency Act 1986.

302 This varies widely from state to state, but see the Uniform Act Sec 9 – typically four years after the transaction.

303 Insolvency Act 1986, Secs 423–425.

304 Sec 151 Delaware Corporations Law.

305 Sec 152 Ibid.

306 Sec 153(a) Ibid.

of the consideration constitutes capital, except that the amount to be capital must be not less than the PV. This amount is to be specified in dollars. Subject to contrary decision of this kind by the directors, the capital is presumed to be the aggregate PV of any PV shares and the aggregate of the consideration received on issue for NPV shares. The amount of capital attributed to NPV shares is called "stated capital".

The balance of net assets over capital (ie aggregate PV plus stated capital) is called "surplus" and the directors may "transfer" surplus to capital. No doubt the directors may properly contract with shareholders as to the amount of consideration to be treated as capital on issue.[307]

B. Distributions

Distributions may be paid:

(a) out of surplus, or
(b) if there is no surplus, out of the "net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year[308]".

The latter are known as "nimble dividends". However they may not be paid if the net assets are less than the capital "represented by the outstanding stock…. having a preference on distribution of assets" and no such distribution may be made until "the deficiency" is "repaired".

(These nimble dividend provisions allow for the fact that when a corporation is in deficit but earning current profits it is arguably too harsh to prevent it from providing a return on equity and from raising fresh equity, at an appropriate price, which will be remunerated).[309]

A company exploiting wasting assets need not take account of their depreciation before distributing profits.[310]

C. Reductions

The par value and stated capital in respect of issued stock may be reduced by: "retiring" (see below) or repurchasing or redeeming shares, by converting or exchanging shares (so long as the stated capital in respect of the new shares is preserved), and by transferring to surplus any capital attributable to PV shares in excess of the PV and any capital represented by NPV shares.[311] But none of these transactions may be done unless the outstanding assets are "sufficient to pay any debts of the corporation

[307] Sec 154 Ibid.
[308] For discussion of the meaning of this Delphic expression see B Manning and J Hanks *Legal Capital* (3rd ed Foundation New York 1990) 82–84.
[309] Considered and rejected by the British Jenkins Committee in 1961, see above. See ch 5.
[310] Sec 170 Delaware Corporations Law.
[311] Sec 244(a) Ibid.

for which payment has not been otherwise provided".[312] Thus subject to solvency the stated capital and par value capital may be very easily reduced.

D. Repurchases

A share buy-back is treated as a distribution. Buy-backs which impair capital are not permitted unless the shares repurchased are preference shares, or if there are no preference shares in issue, unless the shares are to be retired and capital reduced under the rules in C above.[313]

E. Further Aspects

While the Delaware rules seem on their face tougher than the MBCA, the effect, at the cost of some complexity, is to produce a regime where the adoption of a capital reserve is voluntary. Even when adopted, the capital may be permanently eroded by nimble dividends, (a more liberal provision than the MBCA). The whole of any capital apart from par value may be transformed into distributable surplus and even par value may be reduced, by repurchase, retirement, or conversion subject to a weak net assets test.

As with the MBCA, since there is no rigid linkage of the judgment on the net assets test to the accounts, the proposed IAS on options and pensions would appear to present no difficulties for Delaware companies.

While there is no explicit solvency test this is probably substituted for by the fraudulent transfers regime – see above.

Decisions on distributions and capital increases are typically in North America regarded as matters for decision by directors.

Model 9. California – No Par values, No Stated Capital but Stricter Distribution Rules (Retained Earnings or Net Asset Surplus)

A. Payment

Consideration for shares may normally be such as is determined by the board. Promissory notes and future services are not good consideration however.[314] Shares may be "wholly or partly, partly paid" – ie they may be wholly unpaid up. There is no provision in the California code for par values or stated capital, " a statement of par value is not prohibited; it will simply have no legal significance".[315] California thus has a purely NPV regime.

312 Sec 244(b) Ibid.
313 Sec 160 Ibid.
314 Sec 409 California General Corporations Law.
315 Sec 202(d) Ibid., commentary, and see Manning and Hanks, 176.

B. Distributions

Distributions may be made

(a) out of "retained earnings"; or if[316]

(b) (i) the net assets (excluding goodwill capitalized R&D and deferred charges) are not less than 1.25 times liabilities (excluding deferred tax, deferred income and deferred credits); and

(ii) current assets are not less than current liabilities, or if earnings before tax for the preceding 2 fiscal years were less than average interest expense, then not less than 1.25 times current liabilities (special provision being made for (aa) profits derived from exchanges of assets – these must be currently realisable in cash; and for (bb) repeated payments by customers under existing contracts – these can count as current assets net of related costs).[317]

California thus has an earned surplus combined with an alternative more elaborate balance sheet test regime. However the balance sheet test attempts to reflect in some proportionate way the company's financial condition.

C. Repurchases

Repurchases are defined as distributions[318] where they involve a transfer of cash or property to the corporation's shareholders.

D. Reductions

Since there are no par values and no stated capital, provision for capital reduction is not required.

E. Further Aspects

California was a trailblazer in abolishing par values and stated capital. The financial ratios for the net assets distribution rule look rigid, however. The alternative earned surplus rule is replicated in some other states. It is not clear how, for example, IFRS2 or the proposed standard on pension deficits would play into it, but again there appears to be no rigid limitation of the accounting judgments to US GAAP.

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[316] While the test appears to be cumulative, it is in fact alternative, see B Manning and J Hanks *Legal Capital* (3rd edn Foundation New York 1990)176 n 3.

[317] Sec 500 Ibid. There is a similar provision in Alaska, see B Manning and J Hanks *Legal Capital* (3rd edn Foundation New York 1990) 176.

[318] Sec 166 Ibid.

Model 10. Canada (Canada Business Corporations Act and Ontario) – No Par Value but Strict Stated Capital with MBCA-type balance sheet distribution test – but easy redemption and capital reductions

As mentioned in chapter 5, the Canadian Dominion law corporation, which is subject to substantially the same rules as the Ontario corporation, has an unusual combination of an MBCA-type distribution rule with the retention of a capital reserve in a strict form. This is however combined with a dual balance sheet and equity solvency test for distributions, a rather weak regime for repurchases and an even weaker one for reductions of capital.

A. Payment for shares

Shares must have no par value, must be fully paid up and can be issued for any consideration the directors determine,[319] subject to an express obligation on directors to acquire fair value, ie equivalent to the cash which would have been received, where non-cash assets are subscribed.[320] The full amount (no more and no less) of the consideration received on issue of any share is to be credited to the appropriate "stated capital account" to be established for each class of shares.[321] This account or accounts is readily identifiable with the aggregate of share capital and share premium account under British law.

B. Distributions

Dividend declaration is a matter for the directors. To declare a dividend both of the following tests must be satisfied:

(a) there must be no reasonable grounds for believing that after payment the corporation would be "unable to pay its liabilities as they become due"

(b) there must be no reasonable grounds for believing that "the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes".[322]

There is a personal liability on directors for payment of excessive dividends.[323] It is evident from (b) that the net assets balance sheet test is a matter for directors' assessment and that unrealised profits are distributable reserves.

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319 Secs 24, 25 Canada Business Corporations Act 1985 ("CBCA").

320 Secs 25(3), 118 Ibid. Liability can be escaped if they can show that they could not reasonably have known of the deficiency or if they relied on a professional valuation Sec 123(4).

321 Sec 26 Ibid.

322 Sec 42 Ibid.

323 Sec 118(2)(c) Ibid.

C. Repurchases

These are permitted so long as the consideration paid does not have the effect that there are reasonable grounds for believing that

(a) the corporation "would after the payment be unable to pay its liabilities as they become due"; or
(b) the realizable value of the corporation's assets would after the payment be less than the aggregate of its liabilities and stated capital of all classes".[324]

Note that while a dividend may not reduce stated capital, a repurchase will do so since the stated capital test is to be satisfied *after* the repurchase.

In the case of redeemable shares, test (a) must be satisfied on redemption but test (b) is modified to require only sufficient assets to match liabilities plus stated capital in respect of shares rateable with, or preferred to, the shares redeemed. Thus apparently preservation of stated capital is perceived as something to protect shareholders rather than creditors, since the policy yields where the shareholders concerned rank behind the shareholders of shares with redemption rights.

On repurchase and redemption stated capital is reduced by an appropriate proportional amount.[325]

To emphasize the point here, the capital yardstick is maintained on distributions but not on repurchases of shares. Compare the Second Directive regime above.

D. Reductions

A corporation may by special resolution reduce its stated capital for any purpose, including returning stated capital to the relevant shareholders, so long as there are no reasonable grounds for believing that –

(a) the corporation would after the reduction be unable to pay its liabilities as they become due; or
(b) the realizable value of its assets would thereby be less than the aggregate of its liabilities.

A creditor may within two years apply for the restitution of value received in breach of the section.[326]

Here again the effect of the reduction is of course to reduce the amount of stated capital, leaving creditors with reduced protection.

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[324] Sec 34 Ibid. Note that, if the repurchase is to compromise a debt, eliminate fractional shares, or to settle an obligation to directors, officers or employees, the net assets requirement is relaxed to require only sufficient net assets to match preference capital s 35(1), (3) and both requirements are relaxed entirely if done to satisfy an appraisal or oppression action s 35(2).

[325] Sec 39 Ibid.

[326] Sec 38 Ibid.

E. Further Aspects

The Canadian solution is a curious mixture. Stated capital is more rigid than in Delaware[327] in the sense that it is non-optional and covers the whole of the subscription received. But it can be very easily eroded by repurchase or reduction, though reduction requires a shareholder resolution.

There is no earned surplus test and the balance sheet test is by reference to realisable values.

There is no financial assistance provision in CBCA or the Ontario law.

Model 11. New Zealand – NPV Shares; No Stated Capital; MBCA-Type Distribution Rule but with Solvency Certification

A. Payment

Shares are to have no nominal or par value.[328] Shares are to be issued on terms that are "fair and reasonable" to the company and existing shareholders.[329] The duty of loyalty applies but directors are expressly permitted to rely on properly appointed professionals.[330] Where the consideration is not cash the board must consider and conclude that the cash value is no less than the amount to be credited for the issue.[331]

B. Distributions

Distributions are authorized by the board which must be satisfied on reasonable grounds that the company will, after it is made, satisfy the "solvency test"[332] – ie a twofold cumulative test:

(a) the company must remain able to pay its debts as they fall due; and
(b) the value of the company's assets must exceed the value of its liabilities, including contingent liabilities; and
(c) the directors authorizing the dividend must sign a certificate that this will be so, stating their grounds.

It is expressly stated that "debts" includes (subject to contrary provision in the articles) any fixed preferential return on prior ranking shares and "liabilities" includes contingent liabilities and, again subject to contrary provision, to "fixed preferential" (presumably capital) claims in a winding up or on earlier redemption. There is a

327 And even than many EU States which allow distribution of share premiums in many cases – see below.
328 Sec 38 New Zeeland Companies Act 1993.
329 Secs 42, 44, 47 Ibid.
330 Sec 131,138 Ibid.
331 Sec 47(1)(d) Ibid.
332 Sec 4 Ibid.

criminal sanction for non-compliance[333] and an obligation on directors to pay any sum not recovered from shareholders, see below.

Directors must have regard to the most recent financial statements and to all other circumstances they know, or ought to know, affect, or may affect, the value of the assets and liabilities, but may rely on reasonable valuations. As for contingent liabilities, they may take account of the likelihood of the contingency and any claim reasonably expected to reduce it.[334]

Unlawfully paid dividends are recoverable unless received in good faith, and by a shareholder who has altered her position, and it would be unfair to require repayment.[335]

C. and D. Repurchases and Reductions of Capital

These are defined as distributions and will accordingly be permitted so long as Sections 4 and 52 are satisfied, as above. Shares acquired are cancelled. Special provisions are made for proportional buy backs and selective buy backs.[336] In the case of redeemable shares, while shares redeemable at the option of the company are treated in the same way as shares repurchased, shares redeemable at the option of the shareholder are treated analogously to debt.[337]

E. Further Aspects

The New Zealand regime is obviously closely modelled on the US MBCA. Indeed one of the leading commentaries invokes the ABA commentary to elucidate the NZ Act.

In spite of the radical approach of the NZ law, unlike the Canadian, it retains the financial assistance offence, though with very liberal exceptions. These allow financial assistance if: (a) unanimously approved by shareholders; or (b) disclosed, approved by the board and made incompliance with the solvency test and with board satisfaction on fairness to shareholders; and (c)if not exceeding 5 per cent of shareholders' funds, for fair value and with disclosure. There is no sanction of invalidity.[338]

Our enquiries in New Zealand to find out whether the experience over the past decade has been satisfactory have confirmed that it has.

The law on fraudulent transfers in New Zealand apparently follows the British model. However note that the common law on creditor protection outside insolvency has been developed in New Zealand and now transferred to Britain.[339] This new law

333 Sec 52 Ibid.

334 Sec 4 Ibid.

335 Sec 56 Ibid.

336 Extensive provisions Secs 59-67 Ibid.

337 A very brief account of Sec 68-74 Ibid.

338 Sec 76-81 Ibid.

339 *West Mercia Safetywear v Dodd* [1988]BCLC 250 (CA UK), following *Nicholson v Permakraft* (NZ) Ltd [1985] 1 NZLR 242 at 249 (Cooke J). See the discussion in ch 5.

imposes stricter duties on directors to have regard to the interests of creditors, rather than shareholders, where there is an imminent risk of insolvency.

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