Companies Act 2006: Capital maintenance and reduction, financial assistance and distributions

This briefing note should be read in conjunction with our earlier briefing, Companies Act 2006: Introduction and background. In this briefing, we consider some of the main changes that the 2006 Act will make in relation to:

- distributions in kind (with effect from 6 April 2008); and
- capital maintenance, including redemption and purchase by companies of their own shares, capital reductions and unlawful financial assistance for the acquisition of shares (in each case, from 1 October 2008).

Distributions in Kind

The Act includes a provision to clarify the law in relation to distributions in kind (ie a dividend paid by the transfer of assets rather than in cash) and specifically to remove doubts arising from the case of *Aveling Barford v Perion*. The amount of a distribution in kind by a company with profits available for distribution will be any excess of the book value of the relevant asset over the amount or value of the consideration for the transfer of the relevant asset. If the value of the consideration given is equal to, or more than, the relevant book value, the amount of the distribution will be nil. If the consideration exceeds book value, the company’s distributable profits will be deemed to increase by the amount of the excess. Provided the relevant company has profits available for distribution and provided these are sufficient to cover the amount of the distribution calculated as explained above, the distribution will be lawful.

However, if there are insufficient distributable reserves to cover the book value, and the consideration received for the distribution does not bridge the gap, there will be an unlawful distribution to the extent of the market value of the assets distributed. Distributions of any type by companies with no distributable profits will remain unlawful. This would include the transfer of property at an undervalue to a member. It is not expressly stated that a transfer to another company controlled by the same shareholder (as in the *Aveling Barford* case) is a statutory distribution. But, section 846 of the new Act refers to distributions “arising in consequence of the sale, transfer or other disposition by a company of a non-cash asset”, so the wording is not limited to transactions with members. This would suggest that these transactions could amount to distributions where carried out intra-group. This is in any case widely accepted as the current position in practice. Groups carrying out internal reorganisations will be able to do so with greater certainty as to the outcome and as to proper accounting treatments.

Financial assistance

There will be extensive changes to the financial assistance regime with effect from 1 October 2008. In many cases, there will be no prohibition on private companies giving financial assistance for the acquisition of their own or their private holding companies’ shares. However, this will still be subject to the rules regarding distributions, reduction of capital and directors’ duties. In summary:
• Where a person is acquiring or proposing to acquire shares in a public company, that company and its subsidiaries (public or private) will be prohibited from giving financial assistance directly or indirectly for the purpose of the acquisition before or at the same time as the acquisition takes place;

• Where a person has acquired shares in any company and incurred a liability for the purpose of that acquisition, that company and its subsidiaries will be prohibited from giving financial assistance directly or indirectly for the purpose of reducing or discharging that liability if at the time the assistance is given the company whose shares have been acquired is a public company (ie even if it was private on acquisition);

• Where a person is acquiring or proposing to acquire shares in a private company, it will not be lawful for a public company which is a subsidiary of that company to give financial assistance directly or indirectly for the purpose of the acquisition before or at the same time as the acquisition takes place; and

• Where a person has acquired shares in a private company and incurred a liability for the purpose of that acquisition, it will not be lawful for a public company which is a subsidiary of that company to give financial assistance directly or indirectly for the purpose of reducing or discharging that liability.

In many cases where the presence of a public company brings the revised rules into play, a simple re-registration of that company as private will thus cure the problem.

When implemented, the amended Second European Company Law Directive will permit public companies to give financial assistance for the acquisition of their shares up to the amount of their distributable reserves. The Act will have to be amended to accommodate this.

The “whitewash” procedure for approving financial assistance (involving a statutory declaration of solvency by all directors and an auditors’ report) will be abolished. Some practitioners have questioned whether or not the Act adequately disposes of the relevant common law rules relating to maintenance of capital. They have suggested that companies giving financial assistance which materially reduces net assets may have to go through the new form of reduction of share capital without court approval (as to which see below). Otherwise, lenders and others will not achieve certainty over the validity of security etc. Most investors will of course wish to prohibit such steps under contractual provisions, eg in loan and security documents. Additional saving provisions have been promised to clarify that a transaction which would have been lawful if duly “whitewashed” under the existing provisions will be lawful under the new law. The scope of these provisions will need careful scrutiny when published.

Note that the new Act will not provide carte blanche for companies to make any payment in relation to the acquisition of their shares. Some transactions which might cause concern under the existing financial assistance prohibition may still be caught under the new regime, eg by the restrictions on payments to directors and others in connection with loss of office or employment. For example, arrangements for resigning directors to acquire company cars etc. may need careful consideration. Other transactions may, on careful analysis, amount to reductions of capital. Additional steps will be needed in these cases, as explained below.

Redemption and purchase of own shares

From 1 October 2008, private companies will no longer require authority in their articles to issue redeemable shares. Public companies will still need express authority in their articles to do so. The terms and manner of redemption need not be specified in the articles but may - if the articles or a members’ resolution so provide - be determined by the directors before the shares are allotted. Terms of redemption will no longer need to provide for payment on redemption, so deferred payment or instalments will be permitted for the first time.

Companies will be able to purchase their own shares unless there is any restriction or prohibition in their articles. Currently, the reverse applies, with express permission required in the articles.

The DTI has indicated that transitional provisions will require existing companies whose articles do not permit the issue of redeemable shares or purchases of own shares to amend their articles before they can take advantage of the relaxation.

Contracts for off-market purchases of own shares will have to be retained by the company for ten years after completion.

Companies will be able to enter into contracts for off-market purchases conditional on member approval.

Contrary to previous publicity, the provisions relating to purchase of own shares out of capital by private companies will not be repealed. This is in spite of the inclusion in the Act of provisions permitting private companies limited by shares to reduce share capital by special resolution supported by a director’s solvency statement without court approval (see below). Under the capital reduction procedure, it would not be possible for companies to return to shareholders more than the nominal value of the relevant shares - this is possible on a repurchase out of capital. In both cases, the company will need to take into account all contingent and prospective liabilities in establishing its continuing solvency, not only those relevant for section 122 Insolvency Act 1986.
Capital reductions

In addition to the existing procedure whereby a company may reduce its capital with consent of the court, from 1 October 2008 there will be a new procedure for non-court approved reductions by private companies limited by shares. Such a reduction would have to be supported by a written solvency statement by all the directors. This declaration will be along very similar lines to the existing financial assistance statutory declaration, but with no requirement for an auditors’ report. The reduction will need to be approved by special resolution. The reduction will create a non-distributable reserve in the company’s accounts (unless later regulations provide exceptions to the bar on distribution). This procedure will allow speedier and cheaper reductions where, for example, directors have no reason to be concerned at the prospect of claims from creditors. However, if a company carried out such a reduction and was then the target in an acquisition, a buyer would need to carry out very careful investigations to ensure the procedure had been duly carried out. Contrast a court-approved reduction, which is conclusive for all purposes and cannot later be re-opened.

Companies will be permitted to seek a court-approved reduction of capital without express authority in their articles. Currently, the articles must expressly permit this. Articles may instead be drafted in future so as to prevent such an application.

Once again, lenders and other investors will wish to control and restrict the reduction of share capital - with or without court approval - by way of contractual provisions, so as to protect the value of their investment.

Please get in touch with your usual Wragge & Co contact, or one of the partners named in the box, for further advice.

Useful links

For the Companies Act 2006, see:

Or perhaps more useful, the related DTI guidance notes (which do not have legal effect):