



Reduction of Share Capital



Preliminary

Up until the coming into force of the Companies Act 2006 ("2006 Act") a reduction of capital, for both private and public companies, needed a Court Order. Very often these reductions were used to eliminate a deficit on the profit and loss account. By doing so a company can be put in a position where it can pay dividends. This is because accumulated realised losses block a company's ability to pay dividends even where the company is trading profitably.

The 2006 Act introduced a radical new procedure for private companies. This allows them to create distributable reserves by cancelling share capital and/or a share premium account. The old procedures were more limited and effectively only allowed a deficit to be eliminated until such time as the then creditors were paid off.

This Fact Sheet explains the new procedure.

Solvency Statement Procedure

The new procedure became available as of 1 October 2009. The procedure is available only to private companies.

In its consultation on the 2006 Act, the DTI (now BIS) proposed that a reserve created by a reduction of capital supported by a solvency statement should only be able to offset realised losses rather than create a realised profit that could be immediately distributed to members. This would have severely limited the procedure but the Government subsequently decided that a reserve created under this procedure should simply be a realised profit for distribution purposes under the 2006 Act. This was achieved through the Companies (Reduction of Capital) Order 2008.

Authority Under Articles

You should first check the Articles of Association prior to seeking shareholder approval for a reduction of capital.

A private company is permitted to reduce its capital under the new solvency statement

procedure unless there is a specific prohibition or restriction in its Articles (Section 146(1) 2006 Act). Under the old rules of the Companies Act 1985, it was a requirement that the Articles specifically authorised the reduction.

If the articles do contain a prohibition or restriction on reductions of capital, they can be amended by special resolution of the shareholders.

Creditor Protection

In contrast to Court approved procedures, there is no right for a creditor to object to a reduction of capital under this procedure. A measure of creditor protection is provided by the express requirement that the solvency statement take account of all liabilities. This means prospective and contingent liabilities must be considered.

Other Matters

A reduction of share capital cannot be used to reduce the share capital to zero. This is the same as the law on share buy-backs.

A reduction may require consent under a bank facility or shareholders' agreement. A reduction may also mean that share options need to be modified.

Directors' Solvency Statement

The Directors will need to consider very carefully the effect of the reduction of capital before signing a solvency statement. The solvency statement is to the effect that the company will be able to pay its debts as they fall due for at least 12 months. The act requires that prospective and contingent liabilities should be taken into account.

Whilst not a specific legal requirement, it would be prudent for the Directors to make the solvency statement having regard to up to date management accounts and financial projections for (say) a 15 month period. This will assist the Directors in showing that they had exercised reasonable care, skill and diligence in forming the opinion in the

solvency statement. It is a criminal offence for a Director to sign the solvency statement without having reasonable grounds for the opinions expressed in it. The penalty is imprisonment for up to 12 months and a fine.

Where the company is dependent on a key supplier, customer or market, the Board should consider the likelihood of a material problem arising with that supplier, customer or market. It would be prudent for the basis of the opinion to be documented.

There is no requirement that the Company obtains a report or opinion supporting that of the Directors. However, a comfort letter from the company's accounting advisers or auditors may be a good idea as evidence to show that the Directors have acted reasonably.

The solvency statement must be dated and must be signed by all the Directors, no more than 15 days before the date the resolution approving the reduction of capital is passed.

Members' Resolution

The decision to reduce the share capital must be made by special resolution passed by members holding 75% or more of the issued share capital.

The solvency statement must be sent or submitted to each member at the same time, or before, they are sent the resolution. This gives rise to a potential problem as, by default, a written resolution will lapse if the required signatures are not obtained within 28 days whereas in this case the resolution needs to be passed within 15 days of the date of the solvency statement. When circulating the resolution, the Company should highlight the importance of it being signed and returned within the 15 day period.

If a general meeting is to be held the solvency statement must be available for inspection throughout the meeting.

Date Reduction Takes Effect

The resolution to reduce the share capital does not take effect until a copy of the



solvency statement, the member's resolution, a supporting Statement of Capital (using Form SH19) and a statement of compliance by the directors confirming that the solvency statement was made no more than 15 days before the date the resolution has passed, is filed at Companies House. These documents must be filed within 15 days of the members' resolution being passed.

The Statement of Capital must show the prescribed particulars for the reduced share capital. This means the number of shares and their nominal value and the amount paid up, including any share premium, on each share should be shown.

Practitioners have had considerable difficulty with the 2006 Act regime of statements of capital. The company may not have records showing which historic issues of share were made and what the premium (if any) was.

Companies House has recognised this difficulty and has indicated that if the information is not available the nominal value alone can be shown or an average nominal value. In the context of a reduction of capital where creditors are being put on notice of a reduction (particularly one that creates distributable reserves) this would seem contrary to the purpose of the legislation. The legal effect of Companies House's advice may be questioned. Furthermore since the reduction is not effective until the solvency statement and statement of capital are registered, this could leave a company in the position of paying an unlawful dividend.

The Government announced proposals to modify the statement of capital requirements

in 2010 and subsequently decided that the best way to do so would be to introduce all changes simultaneously in order to minimise further confusion. It is understood that detailed proposals will be published as soon as a suitable legislative vehicle is available.

Directors' Insurance

Directors may want to check that any Directors' and Officers' Liability Insurance would cover the costs of defending any prosecution under the relevant section before they sign a solvency statement.



For anyone needing any corporate or technical legal support, there is no-one better to work with.

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