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ARTICLE

Realising Investment in the UK under the Companies Act 2006

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Realising an investment in a company registered in the UK can be a complicated procedure for shareholders, with intricate legislation dictating how and when they are able to extract their wealth from a company.

The Companies Act 2006, which received Royal Assent in November 2006 and will be implemented in full by October 2009, consolidates changes made to company law in the UK over the last 20 years, whilst also introducing many reforms. The approach to legislating was to 'think small first', introducing a more lightly regulated regime for private companies.

This article considers the effects on shareholders wishing to extract their wealth from a company registered in the UK and also notes some potential risks to those dealing with companies from which shareholders are extracting value.

The Act has a significant impact on one of the core concepts of UK company law – that of share capital maintenance. The basic principle of this, is that maintaining share capital and only distributing profits available for the purpose, provides a 'buffer' so as to balance the perceived dangers created by limiting the shareholders' liability. The theory is that money invested by shareholders cannot be withdrawn without due process, thereby protecting unsecured creditors.

Many commentators have questioned how effective these rules actually are in protecting the position of creditors given that there is no minimum capitalisation required to set up a company and in any event the non-distributable capital can be eroded by unsuccessful trading. Consequently, many see the restrictions placed on private limited companies in the UK as both unnecessary and overly bureaucratic. The Companies Act 2006 aims to address these concerns.

Existing legislation

Before evaluating what is different about the Companies Act 2006, it is appropriate to outline some of the more usual ways a shareholder may expect to realise his or her investment in the UK under existing legislation.

Dividends

Under current law, companies may only pay a dividend to shareholders from profits that are available for the purpose. A payment may only be made from accumulated realised profits less accumulated realised losses. In addition to this, public companies, regardless of whether they are listed, must take into account any net unrealised losses, as a dividend cannot be paid if the net assets would be reduced to less than the company's called up share capital and undistributable reserves.

Common law also requires directors to act in the best interests of the company, meaning that they should not pay a dividend which may be compliant with the Companies Act, but where, for example, the outflow of cash will jeopardise the company's prospects.

Sale of shares

The sale of shares is an obvious option for a shareholder wanting to realise his or her investment for both listed and privately held companies. It may be the case, however, that there is no external market for the shares of an unlisted company, or that the other existing shareholders are unable or unwilling to buy. This is particularly true for owner-managed businesses where there is no clear successor and the owner 'is' the company.

Members' voluntary (solvent) liquidation

This is the only risk free way to distribute legally, share capital and reserves which are otherwise non-distributable, and the process requires the services of a licensed insolvency practitioner, to act as liquidator. It pre-supposes that the company will not continue, although it may be possible for the trade to continue if it can be sold to another vehicle before or concurrently with the liquidation. Indeed a members' voluntary liquidation of the company is frequently used where different parts of a company's operations are to be separated into new companies or partitioned between two or more shareholders (or groups of shareholders). Such a reorganisation is usually referred to as a section 110 scheme which is a useful, tax efficient mechanism, often used when preparing a business, or part thereof,

for a future possible sale. Oddly, this power is contained within s. 110 of the Insolvency Act 1986, although no insolvency is involved.

Conversion to unlimited status

When a company converts from limited to unlimited status, the usual restrictions on distribution do not apply as the shareholders then have unlimited liability to contribute in the event of the company's subsequent insolvency. Plainly this is a high risk strategy, certainly if trading is to continue, but in any event, the members must be absolutely sure that they have identified and quantified every actual and potential claim.

ESC C16 application/strike off

Many directors seek to eliminate redundant companies using the tax Extra Statutory Concession C16, followed by an application to the registrar of companies for the striking off of the company (s. 652A Companies Act 1985, to be replaced by s. 1003 Companies 2006).

Put simply, ESC C16 is an application to HM Revenue and Customs for clearance that a distribution made to the shareholders can be treated as capital rather than income for tax purposes. This is beneficial from a tax perspective as any gain on the investment is subject to capital gains tax rather than income tax which is typically at a higher effective rate. What this clearance does not do, however, is to legalise a distribution made out of non-distributable funds.

Upon dissolution of a UK company all unrealised assets become vested in the Crown Estate as bona vacantia (meaning without ownership). The Treasury Solicitor has the responsibility to collect such assets, including any illegal distribution, on behalf of the Crown.

The Treasury Solicitor's latest guidance is that he will not seek to recover amounts of less than GBP 4,000, which effectively puts a cap on the circumstances when this procedure is likely to be used. This reflects the commercial reality of the cost of legally distributing such non-distributable funds (by way of a solvent liquidation) or indeed the probable cost of recovery by the Treasury Solicitor himself.

Key changes under the Companies Act 2006

The procedures mentioned above remain unchanged by the new Act, except as regards the time periods for the possible restoration of a dissolved company to the register in the event of a challenge being raised, which is discussed further below. So, what are the main changes proposed in the arena of capital maintenance and how will they impact?

The key changes to procedure are in respect of financial assistance given by a company for the purchase of its own shares and in respect of a reduction of capital.

Purchase of own shares

Historically, the prohibition on financial assistance has not only been linked to capital maintenance, but was also intended as an anti-fraud device. The CA85 (s. 151) includes a general prohibition making it illegal for a company to provide financial assistance, either directly or indirectly, for the acquisition of shares in itself or its holding company. This basic prohibition has been considered too restrictive for some time now so a procedure was introduced in the early 1980s for private companies, allowing them to be transparent about their current financial position and to demonstrate that the transaction does not have an adverse impact upon the company's solvency.

This procedure is costly and cumbersome to implement as it requires a number of conditions to be met, namely:

- The net asset position must not be reduced unless such a reduction is made from distributable reserves
- The directors must make a statutory declaration stating i) to whom assistance will be given; and ii) that in their opinion, immediately following the date on which the assistance is proposed, that the company will be able to pay its debts as they fall due for the next year
- The auditors must report on the directors' declaration
- The shareholders must pass a special resolution to approve the assistance
- The resolution, the auditors' report and the statutory declaration must be filed at Companies House
- Financial assistance must then be given within the next 4 to 8 weeks.

An incorrect signing of the statutory declaration by directors carries with it financial and/or criminal sanctions.

This so-called 'whitewash' procedure must continue to be applied to all transactions where financial assistance arises until 1 October 2008. Thereafter, sections 677-682 Companies Act 2006 will abolish the prohibition on financial assistance for private companies only.

As regards public companies or their subsidiaries, s. 682 CA06 provides more flexibility for plc's to provide financial assistance for the acquisition of shares in certain circumstances and introduces a whitewash procedure for plc's which, although similar in its

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requirements, is more onerous than the previous private company procedure.

The practical implication of the repeal of the whitewash procedure for private companies is to make the process much more cost effective as there will be no requirement for an auditors' report, although the directors will need to sign a statement of solvency. The directors will also need to consider issues of corporate vires (at least until October 2009), commercial benefit and an unlawful return of capital. In addition, an incorrect signing of a statement of solvency still carries potential criminal sanctions. The directors will therefore be well advised to continue to take relevant professional advice.

But isn't this a retrograde step? Many will wonder what happened to protecting the position of creditors and maintaining the creditors' buffer.

Reduction of share capital

Typically, a company may seek to reduce its share capital where its net assets are no longer represented by share capital and distributable reserves.

This situation usually arises when a company has returned to profitability after a period of sustained losses, so that essentially it has a negative profit and loss reserve, creating a dividend trap. If the share capital is reduced then distributable reserves can be created, allowing profits to be paid to shareholders.

Under s. 135 CA85, a company can only reduce its share capital with the court's permission. It must also have the power to reduce its capital in the articles and a special resolution of its members is required to authorise the reduction.

With effect from 1 October 2008, however, s. 641 CA06 will allow private companies to reduce their capital, without the sanction of the court. Although the court procedure will still be available, and in fact must still be used by plc's, these provisions remove a significant barrier to a private company undertaking the procedure, both in terms of time and cost.

In addition, from 1 October 2008, private companies will no longer require specific authorisation within the articles to allow a reduction in share capital, although it will be possible for the articles to include a provision restricting the directors' power in this regard.

In terms of procedure, the directors must obtain a special resolution from the members authorising the procedure, sign a statement of solvency and a statement of capital and file all these documents with the registrar at Companies House within 15 days. The solvency statement must also be made not more than 15 days before the date the special resolution is passed and must state:

- That the company is currently solvent, and
- That the company is able to pay its debts as they fall due during the year subsequent to the capital reduction having taken place

This statement is not a sworn document, but making a solvency statement without reasonable grounds for the opinion expressed within it will be a criminal offence, so again directors will be wise to take professional advice when contemplating such a statement. Directors should ensure that as well as actual liabilities, contingent liabilities potentially arising in the period are properly considered.

As a minimum, directors should review the latest management accounts and consider the trading and cash flow forecast position at a board meeting in order to satisfactorily evidence that they have fulfilled their statutory duties in this respect.

An independent professional review will provide comfort that the forecasts are sufficiently robust and that the assumptions underpinning them are reasonable and will provide further reassurance for the directors when placing reliance upon them for the purposes of signing the statement of solvency.

Evidence of such advice indicates that the directors have sought to act in the best interests of the company and will also protect their position should the company become insolvent in the future.

The issue then arises as to whether the reserve created by the reduction in share capital is distributable. Subject to the Department for Business, Enterprise and Regulatory Reform not deviating from the regulations which are currently in draft, such a reserve will be treated as realised and therefore distributable.

So, with effect from October 2008, a private company registered in the UK, need only obtain a special resolution supported by a solvency statement, which must be signed by all of the continuing directors, and submit a statement of capital in order to reduce its capital base. This procedure does not require the involvement of the court, an insolvency practitioner (as there is no liquidation), or an auditors' report supporting the directors' solvency statement. The procedure is consequently cheaper and quicker. But once again, what has happened to the principal of protecting the creditors' buffer?

Restoration to the register

The Companies Act 2006 will, with effect from 1 October 2009, reduce the period in which a creditor (or other person having an interest), may seek to restore a company to the register to 6 years rather than 20 years as now, where the company has been dissolved following a strike off. Hence the strike off procedure will become less unattractive from a risk perspective.

Conversely the period in which application may be made for restoration following a dissolution at the

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conclusion of a liquidation, is to be increased from the current 2 years to 6 years, thereby eroding some of the benefit currently attaching to the use of the solvent liquidation procedure.

Summary

So in practice, will directors seeking to eliminate a company with non-distributable reserves and share capital in excess of GBP 4,000, look to implement a 'self-help' capital reduction scheme (to bring the share capital down to below the GBP 4,000 threshold) and then implement a strike off?

In some circumstances the answer is likely to be yes. If the company is an owner-managed stand alone business and the shareholder has full knowledge of the company's activities, a capital reduction followed by an ESC C16 clearance and a strike off may prove to be more cost effective and less time consuming than a solvent liquidation.

The directors still have a duty, however, to undertake the same level of due diligence pre-capital reduction as would be required pre-liquidation and would be well advised to obtain professional advice on this matter. Long experience has shown that many redundant companies are far from being the clean, empty shells that the directors believe them to be and that there are often assets, or contingent liabilities, or both, that have been overlooked.

It is as yet unclear whether the tax advantages that arise for shareholders as a result of receiving a capital distribution from a liquidation will be available when receiving funds as a result of a capital reduction, as the funds received will arise from distributable reserves and therefore become a dividend income receipt. As a result, unless the tax legislation is amended, the ESC C16 clearance procedure is still likely to be required.

There are further circumstances where a solvent liquidation is preferable, or even necessary, over the capital reduction/strike off route: for instance, the procedure is not available without court involvement for plcs. In addition, in group situations many directors prefer to use the solvent liquidation procedure as it manages personal risk far more effectively, even when a strike off would normally be considered permissible and appropriate.

Solvent liquidation is a procedure which still performs an important function and will continue to be used as a tax efficient and cost effective way of realising shareholder funds. However, creditors, suppliers, customers and employees of UK companies may not feel quite so comfortable knowing that with effect from October 2008, a private company's capital can be readily reduced, without recourse to the court or any professional involvement.

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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