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By email: companiesact2006consultation@berr.gsi.gov.uk

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Our ref: EP3/NDD

Dear Mr Gray,

The Companies (Reduction of Share Capital) Order 2008 and The Companies Act 2006 (Commencement No. 7 and Transitional Provisions) Order 2008 (the 2 May 2008 drafts) ('the draft Orders')

We are responding to your invitation to comment on the 2 May 2008 versions of the draft Orders.

Reduction of Share Capital Order (2 May 2008 draft)

The draft Reduction of Share Capital Order brings welcome clarification of the impact that a reduction of capital has on a company's profits available for distribution.

We question whether the recital at the beginning of the draft Order that it is made in accordance with section 643 is correct. We believe the reference should be to section 654(2).

We agree that:

- (a) the prohibition on distribution in section 654(1) of the Companies Act 2006 (the 2006 Act) should not apply to reserves created on a reduction of capital by unlimited companies or for private limited companies reducing capital either by solvency statement (section 642 of the 2006 Act) or by application to the court (section 645 of the 2006 Act);
- (b) the reserves created on a reduction of capital by unlimited or private limited companies should be treated as realised for the purposes of Part 23 of the 2006 Act; and
- (c) in the case of private limited companies, this should be subject to any contrary requirement of a court order, or, in the case of both unlimited companies and private limited companies, anything in the special resolution authorising the reduction, or in the company's articles.

Reserves arising from prior capital reductions

Draft regulation 7(2)(a) of Commencement Order No. 7 provides that section 654 shall apply to reductions by private limited companies that take effect under the Companies Act 1985 (the 1985 Act) (or the 1986 Northern Ireland Order (the 1986 Order)) on or after 1 October 2008, irrespective of when the special resolution was passed. Consequently, all reserves created by such reductions

are prohibited from distribution. The effect of the Reduction of Share Capital Order is to lift that prohibition for those reserves created on or after 1 October 2008. However, this does not provide clarity about whether the reserves created by capital reductions prior to 1 October 2008 can be treated as realised profits prospectively from that date. We consider that the legislation should remove any doubt that such reserves should be treated as realised profits.

Similarly, we consider that reserves arising from prior reductions of capital by unlimited companies should be treated as realised profits prospectively from 1 October 2008. Neither the draft Reduction of Share Capital Order nor the draft Commencement Order No. 7 are helpful in this respect as unlimited companies have not reduced their capital under any power in the 1985 Act (or the 1986 Order). Their authority to reduce capital lies in a power in their articles (SI 1985/802 - Table E, Articles of Association of An Unlimited Company Having A Share Capital, paragraph 4(e)). We cannot see any policy reason for not removing any doubt about the treatment of such reserves as realised profits prospectively from 1 October 2008. Consequently, we ask that BERR address this issue through an appropriate adaptation of regulation 7(2) in the final Commencement Order No. 7.

Commencement Order No. 7 (2 May 2008 draft)

Interaction of amended section 641 of the 2006 Act and sections 18 and 20 of the 1985 Act

Draft regulation 3(2) proposes to amend section 641 of the 2006 Act such that a private company limited by shares that reduces its share capital must include in the special resolution the necessary alterations to its memorandum of association. However, in the transitional period this may cause an administrative burden on companies through the interaction with section 18 of the 1985 Act (and the Northern Ireland equivalent), as they would have to file a further copy of the resolution and a complete copy of the memorandum as altered by the resolution.

We recommend that the transitional provision should provide a similar relief from this administrative burden to that found in section 138(5) of the 1985 Act. This states that “The minute when registered is deemed to be substituted for the corresponding part of the company’s memorandum, and is valid and alterable as if it had been originally contained therein.”

A similarly worded provision would allow that “the special resolution when registered is deemed to be substituted for the corresponding part of the company’s memorandum, and is valid and alterable as if it had been originally contained therein”. Such a relief would not deny the company filing a copy of its amended memorandum, if it wished to do so. A further adaptation of regulation 3(2) would provide that the substitution would be deemed an alteration of the memorandum for the purposes of section 20 of the 1985 Act (and its Northern Ireland equivalent).

Drafting point

We note that draft regulation 4(1) refers to section 644 of the 2006 Act as “Section 644 of the Companies Act 2006 (reduction of capital supported by solvency statement: registration of resolution and supporting documents)”. This appears to be a typographical error as the heading for section 644 as it appears in the Act is just “Registration of resolution and supporting documents”. Accordingly, perhaps regulation 4(1) should say “Section 644 of the Companies Act 2006 (registration of resolution and supporting documents)”.

Possible amendments to the 2006 Act

Sections 641 to 645

On reading through sections 641 to 645 of the 2006 Act, it is only in section 641 that the resolution to affect a capital reduction is referred to as a ‘special resolution’. To avoid confusion as to the type of resolution that is required, it would be useful if Commencement Order No. 7 is used to amend the wording in the other sections so that they refer at least once to the resolution being a ‘special resolution’.

Section 642

In our response of 1 June 2007 to question 2.51 in the consultation on the 'Implementation of the Companies Act 2006', we requested that there should be a mechanism for notifying stakeholders that the directors of a company intended to reduce capital under section 642 and that there should also be a mechanism for dealing with stakeholder's valid objections to such a reduction. We are not aware that such mechanisms have been put in place and encourage BERR to do so for the reasons given in our response last year, which for ease of reference is repeated in the appendix to this letter. We recognise that the amendment to affect this recommendation requires regulations to be made using the power in section 657. We have been unable to trace whether this section has yet been commenced to enable such regulations to be made. If it has not been commenced, we urge BERR to use the 7th Commencement Order to commence that section and then to make the necessary regulations to effect these changes.

Section 643 and section 714

We also raised a second question in our 1 June 2007 response (see extract included in the appendix to this letter). Essentially this asked whether it was deliberate policy that there should be difference in the point in time when the directors must consider the impact on the company's ability to pay its debts depending on whether it is a reduction of capital (section 643) or a payment out of capital (section 714). As we noted previously, in the case of the former the directors only have to consider the ability of the company to pay its debts "*at the date of the statement*". This is in contrast to a payment out of capital, where the directors have to consider the company's ability to pay its debts "*following the date on which the payment out of capital is proposed*". Since, a reduction of capital followed immediately by a return of that capital is essentially the same as a payment out of capital, it is strange that the rules are not the same and an identical safeguard is not in place for a capital reduction by solvency statement. We are not aware that this issue has been addressed by BERR and again ask whether this is deliberate policy or is something that is to be achieved through regulations yet to be made?

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We shall be pleased to discuss this response with you further. Please contact Nigel Dealy (020 7804 2252 or at nigel.dealy@uk.pwc.com) in the first instance.

Yours sincerely,

Nigel Dealy
Senior Director
Assurance

APPENDIX

Extract from PricewaterhouseCoopers response of 1 June 2007 to the March 2007 consultation on the 'Implementation of the Companies Act 2006'

2.51 Do you agree that the use of a solvency statement in the way we have outlined above is a reasonable way to determine whether the amounts in may be distributable?

Response

We recognise that the use of a solvency statement in this way is a step in the direction of removing from private companies the capital maintenance regime (derived from the EU Second Company Law Directive for Public Companies) and replacing it with a solvency-based regime for distributions. In the context of individual, stand-alone private companies this move is welcomed and we encourage the Government to continue with moves towards such a goal, after due consultations and review for unintended consequences.

However, while we generally welcome the proposal outlined in the consultation paper, we have some reservations that in certain contexts the relaxation afforded by the solvency statement approach could run counter to Government policy on protection of other stakeholders. We expand further on this below.

On the basic proposal, we agree in principle that a surplus created on a reduction of capital by a private limited company using a solvency statement under section 643 of the 2006 Act should be treated as a realised profit. This is particularly important as it avoids the burden of proving that the reduced capital had been paid up in qualifying consideration and thus places it on equal footing with a court approved reduction (with the exception that the courts are now requiring a discernible purpose for a reduction). We also agree that the realised surplus must first be used to absorb any realised losses. However, we believe that any excess should not be automatically assumed to be available for distribution. There are the usual common law restrictions to be considered but as explained below there is a need for some statute protection.

While we support the principle that the surpluses created on the reduction of capital should be treated as realised, we note that there are some limitations to the solvency statement approach. Directors are required (under s643(2) of the 2006 Act) to "...take account all the company's liabilities (including any contingent or prospective liabilities) ..." but there are no grounds under which a stakeholder would either be informed of the process or have an opportunity to make valid objections. We note that the 2006 Act provides such safeguards, for example section 645(4) allows the court to invoke section 646 (Creditors entitled to object to (capital) reduction) for a capital reduction other than the two specified in section 645(2) and in 721(1)(b) (Purchase out of capital – Application to court to cancel resolution).

We appreciate that directors will take their duties seriously when making a solvency statement, not least because of the criminal penalties if they do not have reasonable grounds for the opinions they have reached. However, the time horizon of twelve months for which the directors have to consider whether the company can discharge its debts as they fall due in that period is not particularly long in the context of some long term liabilities, such as pension schemes. We believe that directors would welcome guidance from the Department on this issue, particular if it considers that "all liabilities (including any contingent or prospective liabilities)" in section 643(2) captures these long term stakeholders' liabilities.

Furthermore, we note that the Government's policy towards pension liabilities may be compromised by not providing adequate stakeholder protection. The Pensions Act 2004 provides trustees with reasonable power if there is a pension deficit giving rise to a deficit in profits available for distribution in a subsidiary, as this can result in parent company dividends/returns of capital potentially being Type A events ie the trustees can block such distributions.. The ability for directors

of those subsidiaries with pension fund deficits to use section 643 of the 2006 Act to create profits available for distribution, would reverse the block on the parent company's ability to make distributions, without any real change in the economic position of the group, and thus weaken the powers of the trustees of the pension scheme.

In addition, we note that in undertaking a solvency statement under s714 CA06, the directors are required to consider the ability of the company to pay its debts *"following the date on which the payment out of capital is proposed"* (i.e. explicitly stating it is necessary to take account of the impact the payment out of capital will have on the ability of the company to settle its debts). However, in the case of the solvency declaration under s643 CA06, the directors are required to consider the ability of the company to pay its debts *"at the date of the statement"* (since the date of the statement is clearly prior to any dividend out of the reserves, it is not clear that the impact of any dividend on the ability to repay debts is required to be considered).

In summary:

- We agree that a surplus created by the reduction of capital using a section 643 solvency statement should be treated as realised.
- Although treated as realised, such a surplus should not automatically be available for distribution as the directors should have regard to other stakeholders as well as to their common law duties.
- There should be a mechanism for notifying stakeholders of the directors' intention to reduce capital under section 643 and to provide a mechanism for stakeholders' valid objections.

We recognise that to implement safeguards for stakeholders that this will probably mean that the Secretary of State will need to make use of the power in section 657 of the 2006 Act.

We note, for completeness, that the restriction included in TECH 7/03, which requires the shares to have been issued for qualifying consideration, should *not* be carried forward in the regulations. This restriction reflected the legal framework before the 2006 Act, but is of no relevance today because the regulations to be issued would not be constrained.

We also recommend that the regulations to be made under section 654(2) of the 2006 Act should provide that a reserve arising from a capital reduction supported by a solvency statement is a realised profit unless, or to the extent that, the special resolution provides otherwise.

In light of our comments above, it is very important that a draft of the regulations to be made under section 654 of the 2006 Act is made available for comment for a reasonable period before being finalised to ensure that all of these issues have been appropriately resolved.

Unlimited companies

We note that the consultation document does not cover the position of reduction of capital by unlimited companies. Although an unlimited company can reduce its capital by special resolution, provided it is permitted to do so by its articles, the interaction with section 654 of the 2006 Act means that a reserve arising on such a reduction cannot be treated as a realised profit. We recommend that regulations to be made under section 654(2)(a) of the 2006 Act should expressly provide that capital reduction surpluses for unlimited companies are realised, unless the special resolution of members approving the reduction states otherwise.