Reducing capital by solvency statement – hints and tips for directors

The ICAEW has recently issued a helpsheet on the reduction of share capital under the Companies Act 2006 ("**CA06**"). This forms the background to this alert in which we set out some useful guidance for directors when considering a reduction of share capital under the solvency statement procedure introduced by the CA06.

One of the core principles of company law is that a company limited by shares must maintain its share capital for the protection of creditors. Accordingly, whilst the CA06 does permit the reduction of share capital it requires companies to comply with one of two set procedures.

These procedures are:

- with court confirmation – available to both private and public companies; and
- out of court but supported by a solvency statement – only available to private companies.

In both cases, a shareholders' special resolution is required.

Under the CA06 and subject to compliance with one of these procedures, a reduction of share capital may be effected in a number of ways, unless there is a specific prohibition in its articles of association. A company might use a reduction to repay surplus capital to shareholders, assist in the reorganisation of a corporate group, or create distributable reserves.

We have seen an increase in the number of clients using the solvency statement procedure for reducing a private company's share capital particularly in the context of reorganising and simplifying group structures. A reserve arising from a reduction in share capital using a solvency statement is treated as a realised profit for the purposes of the CA06 and, consequently, it may potentially enable cash or other assets to be distributed to shareholders.

What is a solvency statement?

A solvency statement must be made in writing and signed by all of the directors. In the solvency statement, every director is required to state that he has formed the opinion that (1) there is no ground on which the company could be found to be unable to pay (or otherwise discharge) its debts, (2) if it is intended to commence the winding-up of the company within 12 months of the date of the statement, the company will be able to pay its debts in full within 12 months of the commencement of the winding-up, and (3) in all other cases, the company will be able to pay (or otherwise discharge) its debts as they fall due during the year immediately following the date of the statement.

A director who makes the solvency statement without having reasonable grounds for the opinions expressed in it risks imprisonment and/or a fine.

Can the solvency statement procedure be used to eliminate a deficit on the company's profit and loss account?

This is a question that often arises. It is not uncommon for a company to use a court confirmed reduction of capital to eliminate a dividend block resulting from an accumulated deficit on profit and loss accounts. But can a private company use the solvency statement procedure to do so?

In short, the answer is yes. The reserve arising on reduction may not all be able to be distributed; it must be set against the accumulated deficit first and only once that has been eliminated can the balance potentially be distributable.

What practical steps can the directors take to protect themselves against committing an offence?

Some time ago the City of London Law Society published a memorandum setting out a number of practical steps to reduce the risk of directors committing an offence under the relevant sections of the CA06. Its recommendations included:

- **Recording information relied on in reaching their opinion:** The directors should undertake, and document, due diligence in relation to the company's debts. Any uncertainties regarding the company's liabilities or the resources available to meet them should be addressed.

- **Considering different factors depending on the circumstances:** When forming their opinions, the directors should consider factors appropriate to the circumstances, for example, whether the company is trading or non-trading.
- **Obtaining reports from third parties:** While there is no requirement for a report by any independent third party on the directors' conclusions, they may, in some cases, wish to obtain advice to reach their opinion or seek comfort on the processes that they have undertaken (or propose to undertake) to help satisfy themselves that their opinion expressed in the solvency statement is soundly based. Where directors give proper instructions and take account of the advice or comfort that they have received, it is likely to be helpful in showing that the directors had reasonable grounds for their opinions. But if the directors do not obtain a report from an independent third party or advice or comfort on the processes, this should not necessarily mean that they are unable to demonstrate that they had reasonable grounds for their opinions. We have seen instances where auditors have provided some level of comfort in support of directors' opinions and/or stress testing of company projections. However, this is by no means the norm.

In our experience, directors should also bear in mind the following:

- **Prepare cash flow projections and focus on identification of all liabilities:** The CA06 specifically says the directors must take into account all liabilities (including any contingent or prospective liabilities).
- **The directors should look a minimum of 12 months into the future:** In practice, it may be prudent for directors to consider beyond a 12 month horizon and thereby seek to accommodate some 'buffer' beyond the period actually covered by the solvency statement.

Further practical points to consider when reducing capital by way of the solvency statement route

- **Check the company's contractual arrangements for prohibitions or restrictions on the company's ability to reduce capital:** For example, consent from a third party may be required under the terms of debentures, warrants, banking facilities or guarantees. Obtaining consent from third parties before the reduction of capital is carried out might affect the timing of a proposed resolution. The impact of any reduction in the context of a company's pension scheme (if applicable) should also be considered, together with the powers of the Pensions Regulator.
- **Consider imposing voluntary restrictions on the distributable nature of the reserve arising on reduction:** For example, the shareholders' resolution could provide that the reduction reserve is only distributable when existing creditors have been paid. This would mimic the type of protection that may arise in a court confirmed reduction involving a repayment of paid-up share capital to shareholders, or a diminution of a liability on unpaid shares.
- **The special resolution must spell out precisely what is to occur so that the accounting follows the wording of the resolution:** A common mistake is for the resolution to set out the result of the reduction but not the process by which it is to be effected e.g. the resolution should specify whether shares are to be cancelled and, if so, which shares.
- **Ensure there is at least one non-redeemable share in issue after the reduction:** This is relevant where the reduction involves the cancellation of shares.
- **Take care when using the written resolution procedure:** There is an inconsistency in the CA06 in relation to the timing requirements for written resolutions generally and for resolutions relating to reductions of capital using the solvency statement procedure. The statutory lapse date for written resolutions generally is 28 days whereas the CA06 requires the resolution approving a reduction of capital to be passed no more than 15 days after the directors' solvency statement. There are a couple of practical ways in which this can be addressed.

- **Where a reduction is undertaken to enable a company to make a distribution, the distribution will need to be considered after accounts have been drawn up reflecting the reduction:** Since the reduction is only effective when the relevant paperwork is filed at Companies House, the relevant accounts to determine distributable profits cannot be prepared before filing has occurred.
- **Distribution in specie:** If a distribution in specie is contemplated in conjunction with a reduction of capital, bear in mind that this will typically require a direction by shareholders as part of an ordinary resolution detailing the relevant dividend.

If you would like any further information on reducing share capital or any related issue, please contact:

Richard Smith
+44 20 3130 3849
RSmith@mayerbrown.com

Greg Joynson
+44 20 3130 3192
GJoynson@mayerbrown.com

Annabel Evans
+44 20 3130 3858
AEvans@mayerbrown.com

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