To What Extent Does Legal Capital Requirement Provide a Sufficient Protection to The Creditors:

anExamination the Situation in the UK and the EU Member States.

▪ **Abdussalam Imhimmed.***

Abstract:

Thispaper presents and discusses the concept of legal capital requirement in a wider content,referring to the minimum capital requirement and capital maintenance in-both the UK and EU, in terms of legal instruments, the UK Companies Act 2006, and the Second Company Law Directive. The paper also argues that the legal capital requirement for public companies, both in the UK and the EU has obsoleted and therefore, requires to be abolished. The suggestion would be a greater reliance on balance sheets as an effective mechanism.

1. Introduction

The concept of legal capital is broad; it contains a number of different rules, such as the raising of capital by shares and its maintenanceby avoidingthe return ofthe aforementionedcapital to the shareholders under any circumstances, save as the law permits. Within the European Union (EU). The Second Company Law Directive (SCLD)[1] sets the rule, while the Companies Act (CA) 2006 follows the rule as set down in the SCLD *mutatis mutandis*. The main function of these rules is to protect creditors who, unlike shareholders,whom often cannot influence the management of the company and yet loses credit advanced to the companyin the event of the it becomes insolvent.[2]

The UK CA 1985 had a legal capital rule, which is now reprised in the CA 2006,ostensibly to protect creditors of public, but not private, companies.[3] They imposed the legal capital rules when the company starts its business.

* A member at private law department Sebha University Faculty of Law .

In other words, they imposed a minimum capitalwhich must be kept in case of public companies.[4]The same situation is applicable in Europe by virtue of theSCLD,[5] which will be discussed in greater detail later in this paper.

The situation in the USA, however, is totally different; the minimum capital requirement has become inapplicable in most USAstate.[6]Alternatively, creditors frequently use other devices to protect themselves from the opportunistic behaviours of shareholders including contracts, and reliance on balance sheets, or the latest financial statements in order to determine whether or not to give credit to thecompany.[7]

This paper will discuss and present the concept of legal capital by referring to the minimum capital requirement and capital maintenance under the CA 2006 and SCLD, and the different requirements which separated the two, in terms of, the public companies as thefirst part .The second part looks at the exceptions tothis concept, particularlythe case of private companies. Thirdly, it will pay close attention to the critique on the efficiency of legal capital. Thepaperconcludes by attempting to answer these questions, and argues that the time is now suitable to leave legal capital requirements for public companies.

2. The Concept of Legal Capital

In the UK, the legal capital rule is contained in theCA 2006. The rule has its origin in common law (*Trevor v. Whitworth*),[8] and its inclusion in the Act with respect to public companies is now mandatory as a result of European legislation, particularly,the SCLD and other rules pre- CA 2006.[9] The rule might be divided into two categories: firstly, the rules set out in provisions in respect of raising capital[10] in CA 2006 Company's Share Capital and Allotment of Share.[11] Secondly, the provisions which prohibits the company from returning theshareholders' money (capital) to them under any circumstances, unless in cases for which the law has allowed[12]. In other words, the provisions which require shareholders to pay a certain amount of money on shares taken by them (nominal value/price) is called Minimum Capital Requirement, and theprohibition of the return of this money to shareholders and instead keeping the money, thereby trading it as a cushion in order to protect creditors in the event of company insolvency- is known as Capital Maintenance.

2.1Minimum Capital Requirement in the UK and the EU

On the one hand, the minimum capital requirement has been introduced in

the UK under CA 2006 section 763 (1).[13] "The authorised minimum, in relation to the nominal value of a public company's allotted share capital is- (a) £ 50,000 or (b) the prescribed euro equivalent". [14] Therefore, any business outfit that intends to incorporate as a public company in the UK must have at least £50,000 in respect of the nominal value. Section 568 further requires public companies to ensure that at least one quarter of the nominal value of its shares be paid-up. The section reads "*a public company must not allot a share except as paid up at least as to one- quarter of its nominal value and the whole of any premium on it*".[15] For instance, if a public company incorporates, the subscribers may pay 25 pence, if the nominal value of a share is £1, this is called 'partly paid- up shares', and the rest of the amount, which is 75 pence,is called 'uncalled shares.'[16]

On the other hand, according to Article 6 the SCLD, the minimum capital for public companies as contained in 25,000 Euros.[17]Article 9 SCLD also states that the subscribers or shareholders cannot pay less than 25% of the nominal value of a share.[18]

2.2Capital Maintenance

The origin of capital maintenance in the UK can be traced to the common law case ofTrevor v. Withworth.[19] In this case the court ruled that the company could not change its capital or give it back to the shareholders without approval from the court.[20] This means that the court restricted the power of limited liability companies to reduce the amount of money, which subscribes as a share capital, in order to protect the potential creditors.Also, in*Guinness v. Land Corporation of Ireland*[21] the court held that the paid-up shares might not be returned to the shareholders because this would reduce the amount of money, which the creditors of the company have the right to receive in the event of bankruptcy.[22]

From the discussion so far, it can be clearly observed that there is a close relationship between the minimum capital requirement and capital maintenance. Minimumcapital is seen as the start-up capital of public companies, and the amount of which it must keep throughout its life in order to protectpotential creditors. Capital maintenance requirement plays a complementary role by restricting the return of this amount to the shareholders[23] .Generally speaking minimum capital can be viewed as a fee to enter thegame; after-

wards, the capital maintenance could be viewed as the rules of the game.[24] This is as a metaphor on thread- two concepts.

2.3 Unlawful Return of Capital

There are three ways in which public companies are not allowed to return capital to the shareholders: share repurchase, giving financial assistance, and undervaluing transactions between the company and its members.

1.1.1 Share repurchase

Public companies are not allowed to acquire or buy theirown shares as a general rule, although the CA 2006 has some restrictions on this rule.[25] Further, private companies are excluded from this constraint according to section, 692(1) of CA 2006.[26]

1.1.2 Giving financial assistance

Thisfinancial assistant provided in order to buy its own shares.[27] CA 2006 defines the financial assistance under section 677 by way of gift, guarantee, security or indemnity, loan, release or waiver, novation or assignment.[28]

2.3.3Undervalue transactions between the company and its members

Sometimes members demand that the company sells assets to them for less than their real value.[29] In other words, members ask the company to subsidize shares by selling it less than the true worth;or, alternatively members may ask the company to buy assets from them at expensive price(higher prices)in order to obtain the benefits for the exceed amount of money.[30]

2.4Restrictions on a share premium account that returns to the shareholders (non- distributable reserves)

Share premiums set out under CA 2006 section 610 application of share premium (1) "if a company issues shares at a premium, whether for cash or otherwise, a sum equal to aggregate amount or value of the premiums on those shares must be transferred to an account called "the share premium account" [31] and the same section Paragraph(2) sets out the usage of this account (a) "the expense of the issue of those shares; (b) any commission paid on the issue of those shares."[32] Further, (3) form the same section stated the share premium account might use to pay up new shares, which will give to the members as fully paid up share bonus[33] .Finally, section4 share premium

considers as a part of the capital shares, so it cannot be distributed, only in cases which have been just mentioned.[34]

Therefore, if a company issues shares and which thereafter obtain a value that is higher than the nominal value of the a share, the company must keep this excess amount in a separate account called the' share premium account', in order that the company may use this account for an expenditure as prescribed above but not otherwise. Thus, if the company uses the money ina share premium account in a manner other than permitted, this wouldunlawful distribution.

3. Exceptions on the legal capital (Private Company)

It was mentioned earlier that section763 (1) (a) imposes a minimum capital requirement of £50,000, in public companies[35] although, thisexcludes private companies from any requirements.[36] However, the position in EU member states is governed by SCLD article 6, which imposesaminimum € 25,000 for public companies, and leavesmember states to decide the minimum requirement for private companies.[37] It is in line with this provision that the UK removed the capital requirement for private companies, while continental Europe retained the requirement for private companies. This has led to some court decisions on the matter. For instance, in the case of*Centros Ltd v Erhvervs- ogSelskabsstyrelsen[38] , a* private company was registered by Danishin the UKafterwards, he applies to register a branch in Denmark and the Danish authority refused to register it because they felt it was a scheme to avoid paying the minimum requirement for private company under Danish company law.[39] The European Court of Justice (ECJ) held that the refusal was incompatible with Article 52& 58 of the European Community Treaty (ECT)[40] which enshrines the principle of freedom of establishment within EU member states.Significantly, the ECJ noted that legal capital was not important as a creditor protector, and that other restrictions or guarantees could be put in place to protect the creditors.[41]

According to this judgement the opponents of legal capital may build their argumentto remove or abolish the legal capital requirement. Further, in *Inspire Art Ltd*[42], a case which bore many similarities to the previous case, the private company was established in the UK but operated its main business in

the Netherlands, wherein the Dutch authorities argued that it should be registered again as a foreign company. The ECJ held that it was immaterial, as the company was merely exercising its right to freedom of establishment within EU membersstates, even though it was clear that the only reason for choosing to be incorporated in England was to avoid paying the minimum requirement.

The two ECJ decisions set a trend upon which toreflect the future of the minimum capital requirement within the EU.Notably, the ECJcriticised the notion that legal capitalwas out-dated;it did not protect potential creditors, and unequivocally stated that it wasunimportant to creditors as they were able to protect themselves by other means, such as adding extra clauses to a contract or providing a last financial statement.[43]

After the ECJ judgement many EU member states have changed and/or reduced minimum capital requirements in relation to private companies. For instance, Germany, the Netherlands, France and other EU member states have reformed their laws for the purpose of reducing minimum capital requirement in relation to private companies.[44]

4. A CritiqueofLegal Capital

To commence with, arguments for legal capital are considered. Firstly, legal capital mitigates disclosure of information to the company's creditor, and subsequently, the creditors will get the benefits from a reduced cost of monitoring the company.[45] Secondly, legal capital has historical and cultural considerations, particularly, in Europe, so any changes require a substantial effort.[46] Thirdly, the restriction on legal capital in terms of distribution shieldsthe management from shareholders unnecessary pressure to distribute capital.[47] Finally, as long as there is legal capital the creditors will ensure the payments of dividend are not going to be paid from the capital.[48]

On the other hand, those who oppose legal capital requirement base their argument on different elements. Firstly, from an economic perspective, Professors *Enriques* and *Maceyclaimed*argue that the cost of legal capital outweighs the benefits.[49] Where there is legal capital the range of risk will be higher, due to the fact that this capital will be used in the company's operation,rather than left idle, solely toprotect creditors fromthe risk of default.[50] In addition, others havearguedthatlegal capital becomes obsolete. In other words, the value of

money changes over time(inflation) thus making the legal capital increasingly insignificant compared to current debts. For instance, a company incorporated in the 1940s with a minimum capital requirement of£10,000 can hardly count on such capital to satisfy the amount of debts it may have to contend with in 2014. Thirdly, creditors can protect themselves by adding extra clauses to a contract, such as a negative pledge and covenants to guarantee their debt, and by using the latest financial statement in order to ensure their rights and debt.[51] Consequently, the creditors will have nouse for legal capital.

Fourthly, an evidence from the EU suggests that legal capital(minimum capital) discouragesthose people who want to establish a company, but who are unable to raise the requisite amount.[52] In other words, this may create obstacles for anybody who wants to start a business. Fifthly, in terms of adjusting creditors and non-adjusting creditors, theminimum legal capital does not provide a sufficient protection for both of them. To begin with, onthe one hand, voluntary creditors which have agreed to be a creditor i.e. (financial institutions) seems to be unlikely to any bank or financial institution protect themselves with reliance on the legal capital. Further, they instead depends on collect information and add terms to maintain their financial rights. For instance, they can protect themselves by using contractual means, such as a loan agreement and the current balance sheet.[53]

On the other hand, involuntary creditors, namely those who have accidently become a creditor, such as, a tort victim, trading partners and tax authorities. For instance, a trading partner will depend on self- mechanism protection due to the company cannot prescribe any amount will cover all the potential liabilities.[54] Further, the tort victim, even where there is the legal capitalwill often be ranked as a last creditor.[55] Finally, after the ECJ judgements in *CentrosÜberseering*and *Inspire Art*[56] has denied the legal minimum capital to be kept for protecting the creditors,[57].It also states that creditors may rely on other means not to legal capital.[58]

5. Reforms are required to abolish the legal capital requirement for Public companies within the UK and EU because the legal capital does not provide a sufficient protection to creditors.

Above all, it is the view of this paper that legal capital as provided under the CA 2006 and SCLDout-dated, due to the fact that it is not an efficient and

effective mechanism to protect the creditors of a company, and the risk of default borne by the creditors remains high.[59] Furthermore, when a company starts trading, it seems to be difficult to ensure that the company's minimum capital requirement, will be available to the creditors in case the company becomes insolvent.[60] In addition, in relation to the ECJ decisions in *Centros,* Überseering and Inspire Art[61] it becomes clear that the future of legal capital is bleak and the trend is increasingly subject to a reliance on the balance sheet and contracts by creditors. Furthermore, as in the USA has left reliance on legal capital and, alternatively, in most of the U.S states rely on a balance sheet.

6. Conclusion

This paper has discussedin broad terms the concept of legal capital rules under the UK CA and the SCLD, especially in respect to minimum capital requirement and capital maintenance. It takes a view that the legal capital requirement obsoleted, and it is useless to keep it because it does not provide a sufficient protection to creditors. Subsequently,as an alternative option, this paper suggests using a balance sheet (the latest financial statement) as an effective mechanism in order to provide a sufficient protection to a company's creditors.

Footnotes

1. E. Ferran, Principle of Corporate Finance Law (Oxford university press,2008) P, 179.
2. This merely, means the company is unable to fulfil all its financial obligations L. Gullifer& J. Payne, Corporate Finance Law Principle and Policy (Hart Publishing, 2011), 115.
3. Ibid, 115.
4. Ibid, 116.
5. The Second Company Law Directive (71/91-EC,OJL 26/1) A6.
6. See L. Gullifer& J. Payne, Corporate Finance Law Principle and Policy, P 115.
7. Ibid, 115- 116.
8. *Trover v Withworth(1887)* 12 APP Cas 409. The UK CA 2006 is the main legal source of UK company law as well as the case law. It contains 1,300 sections and covering nearly 700 pages, and also 16 schedules.
9. See L. Gullifer& J. Payne, Corporate Finance Law Principle and Policy P,120.
10. Ibid, 120.
11. Companies Act 2006 part 17 Ch 1&2
12. CA 2006 s.763(1) (a) imposes a minimum requirement to the public company 50,000£. L. Gullifer& J. Payne, Corporate Finance Law Principle and Policy

13. Under the UK CA 1985 now under Part 20 Chapter 2 from section 761-767CA 2006. Companies Act 2006 Ch 2.
14. Ibid S763 , (1) , A & B.
15. Ibid, S586, (1)
16. Ibis.
17. The SCLD Article, 6. The SCLD is a EU legislative (directives) concerns the capital requirements of public companies that operating within the EU.
18. Ibid, (9), a.
19. See *Trover v Withworth (1887)*. The fact in this case was the company bought back a significant number of its shares in event of liquidation and one of the shareholders sued the company for getting money after the buy back. The House of Lords stated it was illegal. There is also Re halt Garage (1964) Ltd 3 All ER 1016 where a husband and a wife ran a company the wife became ill which prevented her from doing her job well although she still getting paid her salary and the company getting lost. The court held that the remuneration the wife got, it was indeed out of capital and she must return her salaries.
20. Ibid.
21. Guinness v Land Corporation of Ireland(1882) 22 Ch D 349, CA, 375.
22. Ibid
23. A. Daehnert, ' The minimum capital requirement- an anachronism under conservation': part 2 (2009) Company Law 30 (2), 34-42.
24. Ibid
25. See CA 2006 ,s 658(1) ; Trevor v Withworth (1887)) 12 APP Cas 409 & CA 2006 s690-708 purchase of own shares See L. Gullifer& J. Payne, Corporate Finance Law Principle and Policy.P, 133-134.
26. "A private limited company may purchase its own shares". 692 (2) repurchases must be found out of distribution profits or fresh issue shares. And the director must make a solvency statement the company is able to fulfil allits financial obligation for coming 12 months.
27. See part 18 Chapter 2 from section 677 – 683, Companies Act 2006
28. Ibid S, 677
29. J. Armour 'Legal capital: an outdated concept?' (2006) Centre for Business Research, University of Cambridge7 (1), 5-27.
30. Ibid.
31. CA 2006 part 17 chapter 7,s 610, (1).
32. Ibid (2) A&b (3)& (4).
33. Ibid (3).
34. CA 2006 S 610 (2) A, B & (4).
35. See CA 2006 763 (1) A
36. Ibid

37. SCLD A (6) (1)
38. *Centros Ltd v Erhvervs- ogSelskabsstyrelsen (1999*) 2 CMLR 511.
39. Ibid
40. European Community Treaty 1958 a 52-58. Article 53 sets out 'Article 53. Member States shall not introduce any new restrictions on the right of establishment in their territories of nationals of other Member States, save as otherwise provided in this Treaty'.
41. Ibid
42. In *Kamer Van KoopphandelenFabriekenvoor Amsterdam v Inspire Art Ltd*(2003) E.S.R I-10155.
43. W. Schon, 'The future of legal capital' (2009) European business organisation law review5 (3), 429-448.
44. There is a table shows the minimum requirement in case of private companies some EU states. Ie, Denmark 16,800, Netherlands 18,000 and Austria 35,000 euro and in the case of Germany from '25,000 euro to 10,000'. B.C. Mayer& HF Wagner, Table 6 of M 'where do forms incorporate?',ECEI – Law Working paper NO 70/2006. E. Ferran, Principle of Corporate Finance Law, 91.
45. P. Santella, 'Capital maintenance in the EU: is the Second Company Law Directive reallythat restrictive?' (2008) European Business Organization Law Review 9(3), 427-461.
46. See E. Ferran, Principle of Corporate Finance Law.
47. Ibid
48. I. G. MacNeil, 'An introduction to the law on financial investment'2nd edn (2012, Hart Publishing).P, 267-277.
49. P. O. Mulbert and M.Birke 'Legal capital - is there a case against the European legal capital rules?' European Business Organization Law Review (2002) 3(4), 695-732.
50. See P. Santella, 'Capital maintenance in the EU: is the Second Company Law Directive reallythat restrictive?'
51. Ibid.
52. Ibid.
53. Ibid.
54. Ibid.
55. Ibid.
56. See Centros v Überseering and Inspire Art both of the cases have changed the concept of legal capital, in terms of providing protection to shareholder.
57. Ibid.
58. See J. Armour 'Legal capital: an outdated concept?' (2006).
59. Ibid.
60. P. L. Davies and S, Worthington, Principles of modern company law 9th (Sweet & Maxwell London, 2012). P,272.

61. Ibid. P,272-273.

Bibliography:

Statutory Sources:

1. The Second Company Law Directive 71, 91 EECArticles, 6& 9.
2. Companies Act 2006.S, 763, 658, 568,677,683,610 & 692.
3. European Community Treaty 1958 Articles 52-58.

Case – Law:

4. Trover v Withworth (1887) 12 APP Cas 409
5. Guinness v Land Corporation of Ireland (1882) 22 Ch D 349, CA, 375.
6. Centros Ltd v Erhvervs- og Selskabsstyrelsen (1999) 2 CMLR 511.
7. In Kamer Van Koopphandel en Fabrieken voor Amsterdam v Inspire Art Ltd(2003) E.S.R I-10155.
8. Re halt Garage (1964)Ltd 3 All ER 1016.

Books:

9. E. Ferran, Principle of Corporate Finance Law(Oxford university press,2008).
10. L. Gullifer& J. Payne, Corporate Finance Law Principle and Policy (Hart Publishing, 2011).
11. P. L. Davies and S, Worthington, Principles of modern company law 9th(Sweet & Maxwell London, 2012).
12. I. G.MacNeil, 'An introduction to the law on financial investment'2ndedn (2012, Hart Publishing).

Journal Articles:

13. J. Armour 'Legal capital: an outdated concept?' (2006) Centre for Business Research, University of Cambridge7 (1), 5-27.
14. Daehnert, 'The minimum capital requirement- an anachronism under conservation': part 2 (2009) Company Lawyer 30 (2), 34-42.
15. W. Schon, 'The future of legal capital' (2009) European business organisation law-review5(3), 429-448.
16. P. Santella, 'Capital maintenance in the EU: is the Second Company Law Directive reallythat restrictive?' (2008) European Business Organization Law Review9 (3), 427-461.
17. P. O. Mulbert and M.Birke 'Legal capital - is there a case against the European legal capital rules?' (2002) European Business Organization Law Review3(4), 695-732.
18. M. Becht, C Mayer, and HF Wagner, 'where do firms incorporate',. ECGI – Law Working Paper No 70/2006available atSSRNhttp://ssrn.com/abstract=906066.

مدى توفر المتطلبات والمعايير القانونية لرأس المال والحماية الكافية للدائنين: دراسة الوضع في المملكة المتحدة والاتحاد الأوربي

■ عبدالسلام إمحمد*

ملخص

تسعى هذه الورقة البحثية إلى عرض و مناقشة مفهوم متطلبات رأس المال من منظور واسع، وذلك بالإشارة إلى الحد الأدنى المتطلب لرأس المال ، و مبدأ كفاية رأس المال في كل من قانون الشركات البريطاني الصادر سنة (2006) وقانون الشركات الثاني التوجيهي الصادر عن الاتحاد الأوروبي. تهدف هذه الورقة أيضا إلى تبني القول بأن متطلبات رأس المال للشركات العامة المنصوص عليها في كل من المملكة المتحدة و الاتحاد الأوربي غير فعالة (انتهت صلاحية تطبيقها)، حيث من المستحسن ليس فقط إلغائها، بل استبدالها بالاعتماد على الميزانية العامة للشركة كآلية فعالة.

* عضو هيئة تدريس بقسم قانون الخاص كلية القانون – جامعة سبها.