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Evolution and Impact of Capital Maintenance in UK Company Law

Ogochukwu C. Nweke

School of Business and Leadership (SBL), Regent University College of Science and Technology, Accra, Ghana
Email: bravellb@yahoo.co.uk

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Abstract

This article explores the intricacies of capital maintenance under UK Company Law, tracing its historical roots, pivotal principles, and the legislative safeguards devised to uphold creditor interests. Originating as a judicial response to the inception of limited liability, the doctrine has matured into a robust regulatory framework central to company operations. Fundamental to this evolution are landmark cases such as Flitcroft's, which have anchored the principles ensuring corporate solvency and creditor protection. Nevertheless, the dynamic financial landscape presents its own challenges. The downfall of Polly Peck International in the early 1990s stands as a stark testament to the dangers of neglecting these principles, spotlighting the severe repercussions of financial misdemeanours and unchecked expansion. Additionally, with innovative financial instruments, such as convertible bonds and financial derivatives, traditional boundaries between debt and equity are becoming increasingly indistinct. This evolution prompts a critical reassessment of whether existing capital maintenance rules are adequately equipped to navigate the complexities of today's corporate realm.

Keywords

Capital Maintenance, Corporate Solvency, Financial Irregularities, Modern Financial Instruments, Debt and Equity, Corporate Legal Frameworks

1. Introduction

Capital maintenance, also known as "capital recovery" (Kenton, 2020), is a set of rules designed to see to it that first, a company achieves the capital it claimed to have set out to raise and secondly, that the achieved capital is maintained, within the confines of the demands of the business, for the advantage and safeguard of the interests of the creditors of the company and the performance of its obliga-

tions (Hannigan, 2012). In effect capital maintenance presupposes that a company's capital must necessarily be preserved, because there is usually a part of the capital of the company that is from the contribution of the creditors and preserving or recovering the capital is usually the basis upon which certainty of repayment of creditors' contribution is guaranteed, understanding that reduction of capital invariably diminishes the liability of members and makes the creditors vulnerable and susceptible to the loss of their contributions (Saidul Islam, 2013).

The aim of this article is to assess the regime of capital maintenance, with the particular reference to its origin and foundation, and how it is applied to ensure the protection of creditors of a company and the discharge of the liabilities of a company.

The doctrine of capital maintenance is based on the principle that the income of a company should only be determined as a condition-subsequent, after the recovery of all its costs or after its capital has been maintained (Hannigan, 2012; Kenton, 2020). A company therefore achieves capital maintenance when the total sum of its capital at the end of a particular business period remains the same as when that business period began. The amount in surplus of this total sum is regarded as the profit of the company (Kenton, 2020). In other words, capital maintenance presupposes that a company can only make profit after it has fully recovered the cost associated with running the company's operations within a given period (Upcounsel). This would mean that "to calculate the profit, the total value of the company's financial and other capital assets at the beginning of the period must be known." (Kenton, 2020)

2. Origin of the Doctrine of Capital Maintenance

The doctrine of capital maintenance is a fundamental principle of Company Law (Saidul Islam, 2013) and began as a principle used by the courts to protect creditors. With the introduction of limited liability to the Company terrain in 1855, the courts became more concerned about the protection of creditors, hence the emergence of capital maintenance (Hannigan, 2012). It is rooted in a landmark case in Trevor v. Whitworth (1887), where it was held that "there can be no return of capital to the members other than on a proper reduction of capital duly sanctioned by the courts." In this case, a company repurchased almost twenty-five percent of its own shares. During the winding up of the company, one of the shareholders made an application to the court for the balance of sum owed to him after the repurchase to be paid to him. The Court of Appeal gave judgment in his favour holding that he should be paid. The matter got to the Judicial Council of the House of Lords.

In delivering its judgment, Lord Herschell of the House of Lords said inter alia "If the claim under consideration can be supported, the result would seem to be this, that the whole of the shareholders, with the exception of those holding seven individual shares, might now be claiming payment of the sums paid upon

their shares as against the creditors, who had a right to look to the moneys subscribed as the source out of which the company's liabilities to them were to be met. And the stringent precautions to prevent the reduction of the capital of a limited company, without due notice and judicial sanction, would be idle if the company might purchase its own shares wholesale, and so affect the desired result… I cannot think that the employment of the company's money in the purchase of shares for any such purpose was legitimate."

The case of Salomon v. Salomon & Co Ltd [1897] also showcased the early judicial attempts to tackle the nuances of shareholder rights and creditor protection, thus laying foundational principles for various aspects of company law including capital maintenance (Sealy & Worthington, 2013).

Harman J in the case of Barclays Bank plc v British & Commonwealth Holdings plc [1996] noted that the doctrine of capital maintenance "precludes the return of capital, directly or indirectly, to the shareholders ahead of a winding up of the company" (Hannigan, 2012). See also Aveling Barford Ltd v Perion Ltd [1989], where it was held that on a company's winding up, the shareholders can recover their capital only after all the creditors have been paid their due.

The latter half of the 19th century marked the zenith of the industrial revolution in the UK, necessitating a structured regulatory framework for increased commercial activities. The growth in companies and shareholders spurred the need for financial transparency and protection for creditors (Chandler, 2022).

3. Statutory Basis for Capital Maintenance

The 1980s global business landscape was marked by expansive internationalisation, characterised by an uptick in international mergers and acquisitions. This demanded the harmonisation of business laws across borders (Ohmae, 1989). As companies increasingly operated beyond their native borders, many countries saw a revision in their company laws. The German Aktiengesetz, for instance, also underwent amendments in response to the internationalising economy" (Goergen, 2012).

According to Saidul Islam (2013) case laws formed the basis of the principle of capital maintenance until reforms which took place in 1980 (as reflected in the Companies Act of 1985 and subsequently in the Companies Act of 2006), modified it into a more relaxed rule owing to the exigencies of contemporary business expectations. The effect of this development is that the Companies Act of 2006, established a statutory procedure which allows for shares to be classed as redeemable or capable of being repurchased. In particular:

Part 23 of the Companies Act, 2006 (hereinafter called CA 2006) forbids the distribution of dividends to members of the company, except from profit available for that purpose. See Section 829 CA 2006. See also MacPherson v European Strategic Bureau Ltd [2000]; CA 2006, by virtue of Section 641 further makes it possible for a company limited by shares to reduce its share capital without approval through court order, but through a special resolution supported by a sol-

vency statements endorsed by all the directors of the company according Sections 642 to 644 of the Act; CA 2006 in Section 678 also allows private and public companies to offer financial assistance, but prohibits private companies from giving financial assistance for the acquisition of shares in its public holding company. See Brady v Brady [1988]; CA 2006 through Section 658, forbids a limited liability company from the acquisition of its own shares, except as provided in Part 18 of the Act (Keenan et al., 2009).

The Insolvency Act of 1986 further protects the creditor by permitting for the challenge of any transaction which proves to be injurious to the creditors. Situations where this may arise, include where it can be shown that the transaction is at an undervalue, as seen in Section 238 of the Insolvency Act, 1986 (Hannigan, 2012).

Hannigan (2012) citing the decision in the case of Re R W Peak (Kings Lynn) Ltd [1998] noted that with regards to the redemption and purchase of shares as provided in Section 658 CA 2006, which to a large extent reiterated the position in Trevor v. Whitworth (1887), "strict adherence to the statutory procedures is required for it is only redemption or purchase in accordance with the statutory provisions which is permissible"

4. Impact of Capital Maintenance

According to Saidul Islam (2013) generally and subject to the exceptions available through existing national laws, the doctrine of capital maintenance has the following consequences:

1) A company cannot acquire its own shares unless it does so according to the procedure provided by the Act;

2) A company's subsidiary is not allowed to be a member of its holding company;

3) It is unlawful for a company to provide, directly or indirectly, financial assistance for the acquisition by any person of its own shares or those of its holding company;

4) Dividends must not be paid to the shareholders unless it is so done out of the distributable profits of the company;

5) Where a public company suffers a serious loss of capital, a meeting of the company can be called for the purpose of discussing the situation.

The Case of Polly Peck International (PPI)

The failure of Polly Peck International (PPI), a major UK-based conglomerate in the early 1990s, serves as a significant example. Polly Peck International (PPI) was a UK-based conglomerate that rose to prominence in the 1980s under the leadership of its chairman, Asil Nadir. At its peak, PPI had diverse business operations, ranging from electronics to textiles and fruit distribution. The company's aggressive growth and diversification strategy, paired with a buoyant stock market, made it a darling of the London Stock Exchange (LSE). Its share price surged, and by the late 1980s, PPI had become one of the LSE's top 100 listed

companies (Financial Times, n.d.; Casciani, 2012).

However, beneath this façade of success, there were alarming signs of financial strain. A closer examination of PPI's downfall in relation to capital maintenance principles revealed:

1) Financial Irregularities: PPI's accounts were found to have significant inconsistencies. The company frequently moved funds between its subsidiaries in what appeared to be an effort to bolster its financial health on paper. These intra-group transfers were often disguised as genuine business transactions, making it difficult for outsiders, including shareholders and creditors, to ascertain the company's real financial position (Financial Times, n.d.; Casciani, 2012).

2) Over-expansion without Capital Maintenance: Asil Nadir's aggressive acquisition strategy meant the company was constantly in need of capital to finance its new ventures. Instead of maintaining a robust capital reserve to support its operations, PPI relied heavily on debt and complex financial structures. This lack of capital discipline and over-reliance on debt exposed the company to significant risks, especially when the financial landscape began to shift (Davies, 2010).

3) Decline and Collapse: By the early 1990s, market confidence in PPI began to wane. The discovery of the financial irregularities, combined with growing concerns over the company's solvency, led to a sharp decline in its share price. The company's inability to maintain its capital base and service its burgeoning debt became evident. In 1990, amidst rising concerns about its financial health, PPI went into administration, marking one of the most high-profile corporate collapses in UK history (Financial Times, n.d.; Casciani, 2012).

The downfall of PPI serves as a cautionary tale, highlighting the importance of adhering to principles of capital maintenance. Proper management and maintenance of capital are not just regulatory obligations but essential pillars ensuring the financial health and long-term sustainability of a corporation.

5. Creditor Protection and Discharge of Liabilities

A key feature of the doctrine of capital maintenance is with regard to creditor protection. Creditor protection rules build a fence to ensure that money is not withdrawn from a company or capital reduced to the detriment of the creditor (Sealy & Worthington, 2013). The rules may also further prescribe how money should be invested into a company, and establishes minimum capital requirements. Capital maintenance rules see to it that companies are not allowed to return capital to their shareholders ahead of a winding up except and unless it is done in accordance with statutory procedures established for the protection of creditors (Hannigan, 2012).

According to Hannigan (2012), capital maintenance operates around two kinds of provisions, namely: payment rules; and return of capital rules. These rules exist in the Second Company Law Directive (Second Council Directive, 1977), which prescribes the establishment of public limited companies and the

maintenance and alteration of their share capital.

For the purpose of information, Hannigan (2012) makes us understand that "the Second Company Law Directive is one of the most significant European company law measures for it prescribes in detail the capital rules applicable to public companies, especially with respect to capital maintenance and the rules governing distributions to members. The drawback with the Second Directive has always been the level of prescription imposed by it and there has been pressure in the past on the Commission for reform, if not outright repeal, of the Directive"

A certain part of the interest related to creditors' protection is determined when it comes to their interest in supporting businesses, and ensures that their information on a company's situation remains reliable (Dallas, 2019). However, many creditors still use contract as the best means to protect themselves (Bratton, 2006; Deng & Li, 2023). These contracts which are arranged to address the specific financial requirements of each (individual) creditor enable a more precise calibration of interest rates, ensuring they accurately reflect the risk of potential default by the company. This approach not only offers a direct response to the diverse needs of creditors but also provides an avenue for them to secure safeguards against the inherent risks involved in their financial engagements with the company (Mankowski, 2006). The unrestricted transfer of liability from the corporate sphere to the liability-free sphere of shareholders redistributes assets to the detriment of creditors, which runs contrary to creditor protection and can be associated with an avoidable waste of assets known as efficiency losses, as resources are not being used in a way that maximizes the overall value or welfare (Saidul Islam, 2013; Dallas, 2019).

Equivalent asset transfers before bankruptcy must not be permitted if the latter is caused largely by corporate policy. Evidently, a dividend payout cannot be authorized if it is definite that it will lead to insolvency (Ahmad, 2019). Alternatively, shareholders cannot be deprived of their dividend rights only for the reason that of an increased possibility of insolvency, since each dividend payout inevitably increases this risk (Kirkulak Uludag, 2013).

Capital maintenance rules have historically been put in place to ensure that companies retain sufficient assets to meet their obligations to creditors. The primary idea is to safeguard the interests of creditors by ensuring that companies do not recklessly distribute or reduce their capital. This protects creditors by making sure that funds are available for repayment, particularly in situations where the company faces financial difficulties.

However, the evolution of sophisticated financial instruments and structures has introduced complexities into this landscape:

1) Barriers to Growth:

The stringent nature of capital maintenance rules can be perceived as inhibitive for companies seeking innovative financial solutions to fuel their growth. For instance, companies might find it challenging to raise capital or leverage as-

sets due to the restrictions placed on how capital can be utilised or reduced (Davies, 2010).

2) Blurring Lines with Modern Financial Instruments:

a) Convertible Bonds: These are debt instruments that give the bondholder the right to convert the bond into a predefined number of shares of the issuing company. While they start as debt (which protects creditors by providing a fixed interest payment), their potential conversion into equity can alter the company's capital structure. This introduces a grey area in terms of capital maintenance as the distinction between debt and equity becomes fluid.

b) Financial Derivatives: Instruments like options, futures, and swaps are contracts derived from an underlying asset, such as a stock, bond, or commodity. Their value and cash flows can be tied to the performance of these assets. However, the complex nature of derivatives, combined with their potential to be used for both hedging and speculative purposes, can complicate the assessment of a company's actual capital position.

The increasing use of such instruments means that the traditionally strict boundaries between what is considered debt (a liability to be honoured) and equity (an ownership stake) are becoming increasingly porous. This challenges the practical application of capital maintenance rules and prompts a re-evaluation of how these rules can remain relevant and effective in the contemporary financial landscape (Davies, 2010).

6. Conclusion

As far as the protection of the creditor and discharge of liabilities are concerned, capital maintenance presents itself as a worthy tool. Its application began with the courts and later became a fundamental part of statutes related to Company Law and Practice, not just in the United Kingdom, but in other parts of the world where the advancement of company law and practice is taken seriously. Capital maintenance should never be seen as the enemy of the shareholder, but must be seen as a tool that ensures that activities which pose a threat to the interest of the creditors are circumvented as much as possible. It should also be seen as a means of ensuring that the liabilities of a company are discharged.

According to Saidul Islam (2013) "a limited company should be expressly prohibited from reducing its capital and from purchasing its own shares save as provided in the national legislation and the procedure for the reduction of capital must be designed to protect both creditors and shareholders."

The development of capital maintenance as a statutory doctrine has added a lot of value to what it used to be originally and has helped to create a procedure through which activities are balanced, whether in terms of distribution, financial assistance, acquisition of shares or reduction of capitals.

In the face of evolving financial technologies and globally integrated markets, principles like capital maintenance will likely undergo further refinements. The harmonisation of these laws with the dynamic business environment becomes an

imperative for future legislative considerations (Godwin et al., 2021).

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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