chapter 18

Capital reorganisation, reduction and reconstruction

overview

While the law cannot prevent the reduction of permanent capital (share capital plus non-distributable reserves) which occurs when a company makes losses, it seeks to protect the creditors and shareholders of a limited company by restricting the reduction of permanent capital in other circumstances. We have already explored an example of this in Chapter 4 where we saw that dividends may only be paid out of distributable profits. In this chapter, we discuss the circumstances where a reduction of capital is permitted and explain the strict procedures which must be followed in order to do so.

The law permits limited companies to purchase and cancel their own shares. While it is intended that public companies must keep their capital intact and may only make a 'purchase not out of capital', private companies may purchase their shares in a way which leads to a reduction of capital, a 'purchase out of capital'. We start this chapter with an explanation of both of these purchases.

We then turn to the legal rules which govern the reduction of capital in other circumstances and illustrate such capital reduction schemes. The Government White Paper, *Modernising Company Law*, issued in July 2002, proposes the introduction of new procedures for the reduction of capital based upon a solvency statement by the directors and we outline these procedures.

Finally we discuss the regulatory framework for a wide range of reconstruction schemes and provide an illustration of the design and evaluation of such a scheme.

Introduction

There are many reasons for making changes to a company's capital structure and these range from those which are virtually cosmetic to those where the company's capital base has almost disappeared.

At one end of the spectrum is the share split, which increases the number of shares in issue but does not change the total share capital. For example, shares with a nominal value of, say, one pound may be divided into two shares of fifty pence each or four shares of twenty-five pence each. In the case of quoted companies, this may be done when the price of a share becomes 'too heavy', that is when the market value moves above the range with which investors feel comfortable. There are very few shares quoted on the London Stock Exchange with a market value that exceeds £10.

A company that has large reserves, which it does not intend to distribute, may wish to tidy up its balance sheet by making a bonus issue from these reserves. This involves a transfer between reserves and share capital, thus signalling clearly that the permanent capital of the company has increased and reducing the value of each of the expanded number of shares.

At the other end of the spectrum is the capital reconstruction scheme entered into as the only possible alternative to liquidation of the company. In such a case, the value of the company's assets may be less than the value of its liabilities and the probable result is that the company will be unable to meet its debts as they fall due. The company must then reach some agreement with its debenture holders and other creditors about how their liabilities are to be treated. To achieve economic viability, it will often be necessary to raise new capital from existing shareholders and if, as is likely, the company has accumulated losses, the new shares would probably be unattractive to investors. The writing-down, or reduction, of share capital removes such losses from the balance sheet and brings a greater likelihood of earlier future dividends, thus making the shares more attractive. A possible alternative is that the creditors may take over ownership of the company as was the case with Marconi.

While the term capital reorganisation is a very general one, the term capital reduction has a more precise meaning, that is, it involves the reduction of the permanent capital of the company. Thus a company may wish to reduce its share capital in line with a smaller level of operations or, perhaps, to permit a shareholder director in a family company to retire. The term capital reconstruction is usually applied to those situations where a company is in severe financial difficulties and has to reconstruct its balance sheet. Such a capital reconstruction scheme will frequently involve a capital reduction. A capital reorganisation may be used to effect a change in the relative rights of different classes of shareholders, perhaps when a company is involved in a business combination. Taxation considerations are important in leading a company to reorganise its capital so that its earnings may be distributed to members in a tax-efficient way.

We will, in this chapter, concentrate on various reorganisations of capital permitted under the provisions of the Companies Act 1985.

First, we look at the redemption or purchase of its own shares by a company under the provisions of the Companies Act 1985. We deal with both the purchase of shares other than out of capital, which may be made by any limited company with a share capital, and a purchase out of capital, which may only be made by a private limited company. In the following section we examine the more wide-ranging powers to reduce capital contained in the Companies Act 1985. We also outline proposals to simplify the reduction of capital, which are included in the Government White Paper, *Modernising Company Law*, issued in July 2002.[1] Next we provide the background to other capital reorganisations including those which involve the alteration of creditors' rights. In the final section, we consider the design and evaluation of a capital reconstruction scheme to be undertaken as an alternative to liquidation.

Redemption and purchase of shares

Purchase not out of capital[2]

Until the Companies Act 1981, the only class of share that a company was able to redeem was redeemable preference shares. The Companies Act 1985 now permits limited companies both to issue redeemable shares of any class, and to purchase its own shares, whether or not they were issued as redeemable shares. The difference between a redemption and a purchase is that in the former case the shares will be reacquired on terms specified when the security was

[1] *Modernising Company Law*, Cm 5553-I and Cm. 5553-II, HMSO, London, July 2002. The second volume contains some of the draft clauses for a Companies Bill.

[2] The relevant legal provisions are contained in the Companies Act 1985, ss. 159–70.

issued, whereas in the case of a purchase the amount payable will depend on conditions prevailing at the date of purchase. Apart from this, the rules governing redemption and purchase are the same and, in order to avoid repetition, we shall merely use the term purchase throughout this section. In both cases the purchased shares must be cancelled and cannot be reissued, although the government is considering whether companies should be permitted to retain uncancelled purchased shares as investments as part of their treasury management policies.[3]

The Act distinguishes two categories of purchase: a market purchase and an off-market purchase. The market purchase is a purchase of shares quoted on a recognised investment exchange that is not an overseas investment exchange. It follows that such a purchase may only be made by a public company which has shares quoted on the relevant market. The off-market purchase is any other purchase of shares under a contract and may be made by both public and private companies. In view of the possibility that one particular shareholder may be beneficially treated, the Act lays down more onerous conditions for an off-market purchase than for a market purchase. Thus, while the market purchase may be made in accordance with a general authority passed by an ordinary resolution in general meeting, the off-market purchase requires approval of a specific contract by a special resolution in general meeting.

Private companies are, in certain circumstances, allowed to reduce their permanent capital by the purchase of their own shares and we shall deal with these provisions later in the chapter. With this exception, the 1985 Act lays down very detailed rules to ensure that the permanent capital is maintained intact following the purchase. The general principle, which has applied for many years on the redemption of redeemable preference shares, is that the purchase must be made either out of distributable profits or out of the proceeds of a new issue of shares made for the purpose, or by a combination of the two methods.

In many instances the purchase will be made at a premium, i.e. the purchase price will exceed the share's nominal value. Any premium payable on purchase must be paid out of distributable profits unless the shares being purchased were originally issued at a premium, in which case some or all of the premium payable may come from the proceeds of any new issue, rather than from distributable profits.[4]

Where the purchase is made out of distributable profits, an amount must be transferred to a capital redemption reserve, which is treated as paid-up share capital of the company. Section 170(2) of the Companies Act 1985 requires that the amount of the transfer be found by deducting the total proceeds of the new issue from the nominal value of the shares purchased. It would appear that the intention of the Act is that the amount of the transfer should be such as to ensure that the permanent capital, following the purchase, is maintained at the original level. However, probably unintentionally, due to the particular wording used in the Act, circumstances can arise which result in either an increase or a reduction in permanent capital. The circumstances might occur where shares are purchased at a premium out of the proceeds of a fresh issue of shares itself made at a premium and these will be illustrated in the examples which follow.

First, let us assume that a company purchases shares without making a new issue of shares. In such a case, the amount payable, including any premium, must come from distributable profits and, in order to maintain the permanent capital of the company, it is necessary to transfer an amount equal to the nominal value of the shares purchased from distributable profits to a capital redemption reserve, which is treated as paid-up share capital of the company. This is illustrated in Example 18.1.

[3] See URN98/713, Department of Trade and Industry, May 1998. Retention of uncancelled purchased shares as treasury investments is permitted in many other countries including the USA.

[4] This means that where some of the shares in issue were issued at par with others having been issued at a premium it will be necessary to identify which particular shares are being purchased.

Example 18.1

Bratsk plc has the following summarised balance sheet:

	£
Net assets	1500
Share capital – £1 shares	1000
Share premium	200
(Permanent capital)	1200
Distributable profits	300
	1500

It purchases 100 £1 shares for £160 out of distributable profits.

Summarised journal entries together with the resulting balance sheet are as follows:

	£	£
Dr Share capital	100	
Premium on purchase	60	
Cr Cash		160
	160	160
Dr Distributable profits	160	
Cr Premium on purchase		60
Capital redemption reserve		100
	160	160

Summarised balance sheet after purchase of shares

		£
Net assets	(1500 – 160)	1340
Share capital	(1000 – 100)	900
Share premium		200
Capital redemption reserve		100
(Permanent capital)		1200
Distributable profits	(300 – 160)	140
		1340

Notice that the permanent capital of the company remains unchanged at £1200.

Next let us assume that a company purchases shares out of the proceeds of a new issue. We will assume first that the shares are purchased at their nominal (or par) value. We will deal with the more common situation where the shares are purchased at a premium in later examples. In the absence of any premium payable on purchase, the nominal value of the shares purchased is replaced by the nominal value of, and any share premium received on, the new issue.

Example 18.2

Chita Limited has the following summarised balance sheet:

	£
Net assets	1500
Share capital – £1 shares	1000
Share premium	200
(Permanent capital)	1200
Distributable profits	300
	1500

Chita purchases 100 £1 shares at their nominal value out of the proceeds of an issue of 80 £1 shares at a premium of 25p per share.

Summarised journal entries and the resulting balance sheet are as follows:

	£	£
Dr Cash	100	
Cr Share capital		80
Share premium		20
	100	100
Dr Share capital	100	
Cr Cash		100

Summarised balance sheet after purchase of shares

	£
Net assets	1500
Share capital (1000 + 80 – 100)	980
Share premium (200 + 20)	220
(Permanent capital)	1200
Distributable profits	300
	1500

Once again, the permanent capital has been maintained at £1200.

Frequently, as in the case of Bratsk (Example 18.1), a premium is payable on the shares purchased. Such a premium must be paid out of distributable profits except that, where the shares which are being purchased were originally issued at a premium, all or part of the premium now payable may be paid out of the proceeds of the new issue and charged against the share premium account. The amount which may be charged against the share premium account is the lower of:

(i) the amount of the premium which the company originally received on the shares now being purchased, and
(ii) the current balance on the share premium account, including any premium on the new issue of shares.

Example 18.3

Dudinka Limited has the following summarised balance sheet:

	£
Net assets	1500
Share capital – £1 shares	1000
Share premium	200
(Permanent capital)	1200
Distributable profits	300
	1500

Dudinka Limited purchases 100 £1 shares that were originally issued at a premium of 20p per share. The price paid is £180 and this is financed by the issue of 90 £1 shares at a premium of £1 per share.

Part of the premium payable may be financed from the proceeds of the new issue; the amount is the lower of the original share premium on the shares now being purchased, £20 (100 at 20p) and the balance of the share premium account, including the premium on the new share issue, £290 (£200 + £90), and hence £20 may be debited to the share premium account. The balance must come from distributable profits.

Summarised journal entries and the resulting balance sheet are as follows:

	£	£
Dr Cash	180	
Cr Share capital		90
Share premium		90
	180	180
Dr Share capital	100	
Premium on purchase	80	
Cr Cash		180
	180	180
Dr Share premium	20	
Distributable profits	60	
Cr Premium on purchase		80
	80	80

Summarised balance sheet after purchase of shares

	£
Net assets (1500 + 180 – 180)	1500
Share capital (1000 + 90 – 100)	990
Share premium (200 + 90 – 20)	270
(Permanent capital)	1260
Distributable profits (300 – 60)	240
	1500

So, even where the proceeds of the new issue are exactly equal to the amount payable on purchase, the restriction on the amount of any premium payable which may be charged against the share premium account will often result in part of the premium payable being charged against distributable profits and a consequent increase in the permanent capital of the company. As stated earlier, this appears to be an unintended consequence of the legislation.

In the final example in this section, we look at a company which purchases shares but raises only part of the finance by making a new issue of shares. We shall assume that the shares are purchased at a premium and that the new shares are issued at a premium. As we shall see, it is in this situation that a reduction in the permanent capital of the company may occur.

Example 18.4

Ivdel plc has the following summarised balance sheet:

	£
Net assets	1500
Share capital – £1 shares	1000
Share premium	200
(Permanent capital)	1200
Distributable profits	300
	1500

It purchases 100 shares which were originally issued at a premium of 50p per share. The agreed price is £180 and the company issues 40 shares at a premium of £1 per share to help finance the purchase.

The premium payable on purchase is £80 and part of this may come from the proceeds of the new issue and be charged to the share premium account. As explained above, this amount is the lower of the original premium (£50) and the balance on the share premium account after the new issue (£240). Hence £50 may be debited to the share premium account and the balance must be debited to distributable profits.

As part of the purchase price is being met from distributable profits, it is necessary to make a transfer to capital redemption reserve. Section 170(2) of the Companies Act 1985 requires the amount to be calculated by deducting the aggregate amount of the proceeds of the new issue from the nominal value of the shares purchased. In this case the amount of the transfer is therefore:

	£
Nominal value of shares purchased	100
less Proceeds of new issue (40 × £2)	80
Necessary transfer	20

Necessary journal entries and the resulting balance sheet are given below:

	£	£
Dr Cash	80	
Cr Share capital		40
Share premium		40
	80	80
Dr Share capital	100	
Premium on purchase	80	
Cr Cash		180
	180	180
Dr Share premium	50	
Distributable profits	30	
Cr Premium on purchase		80
	80	80
Dr Distributable profits	20	
Cr Capital redemption reserve		20

Summarised balance sheet after purchase of shares

	£
Net assets (1500 + 80 – 180)	1400
Share capital (1000 + 40 – 100)	940
Share premium (200 + 40 – 50)	190
Capital redemption reserve	20
(Permanent capital)	1150
Distributable profits (300 – 30 – 20)	250
	1400

In this case, the permanent capital has been reduced from £1200 to £1150, which does not accord with the intended aim of maintaining permanent capital. The reason for the reduction is that the proceeds of the new issue are treated as financing part of both the nominal value and the premium payable but this is not recognised by the legislation in specifying the computation of the transfer to capital redemption reserve.

Let us illustrate: the proceeds of the new issue are £80 and, of this, £50 is used to finance the premium on purchase. This leaves only £30 to replace the nominal value of the shares issued. To maintain the permanent capital of the company, the transfer to capital redemption reserve should be calculated as follows:

	£	£
Nominal value of shares purchased		100
less Net proceeds of new issue:		
Total proceeds	80	
less Utilised to finance part of premium payable	50	
		30
Necessary transfer to capital redemption reserve		70

Such a transfer would maintain permanent capital at £1200 but, for the reasons given earlier, it is not the transfer required by law. Section 170(2) makes no reference to 'net' proceeds of the new issue and hence the law seems to permit such a reduction in capital for both public and private companies. The law has been poorly drafted with the consequence that it fails to achieve the objective of maintaining the company's permanent capital.

Purchase out of capital[5]

The permissible capital payment

While failure to maintain capital in the circumstances discussed above may be an unintended effect of the legislation, the 1985 Act specifically permits a private, but not a public, company to purchase its shares out of capital. This provides such a company with a means for reducing its permanent capital without the formality and expense of undertaking a capital reduction scheme, which we discuss in the next section. Such an ability to purchase shares out of capital is of considerable benefit to, for example, a family-owned company where a member of the family wishes to realise his or her investment but no other member of the family wishes, or is able, to purchase it.

A purchase of shares out of capital results in a fall in the resources potentially available to creditors and, as we shall see, the 1985 Act therefore provides a number of safeguards to protect their interests. One of these safeguards is that the company must use all of its distributable profits before it may reduce its capital. Similarly, if a company issues shares to finance the purchase, either wholly or in part, then these proceeds must be used before any capital reduction may occur. Thus the act specifies, what it calls the 'permissible capital payment':

	£	£
Amount payable to purchase shares		X
Less Distributable profits	X	
Proceeds of new issue	X	X
Permissible capital payment		X

The term 'permissible capital payment' is misleading in that it is not a payment but the maximum amount by which the permananent capital may be reduced.

If the total of the permissible capital payment and the proceeds of a fresh issue of shares is less than the nominal value of the shares purchased, there would be a reduction in permanent capital in excess of the permissible capital payment. To prevent this, the law requires that the difference be transferred to a capital redemption reserve but, for the reasons stated earlier, where the shares purchased at a premium had originally been issued at a premium, the reduction in permanent capital might still exceed the permissible capital payment.

If the permissible capital payment together with the proceeds of any fresh issue of shares exceeds the nominal value of the shares purchased, the excess may be eliminated by writing it off against any one of a number of accounts, including accounts for capital redemption reserve, share premium, share capital or unrealised profits. This ability to write off the excess to any one of these named accounts or, indeed, to deal with it in some other way, provides a private company with considerable flexibility to design its own capital reduction scheme.

We shall illustrate the above rules with two examples of the purchase of shares by private companies.

[5] The relevant legal provisions are contained in the Companies Act 1985, ss. 171–177.

In Example 18.5 the purchase of shares is made partly out of capital and partly out of distributable profits, whereas in Example 18.6 the purchase is, in addition, made partly out of the proceeds of a new issue of shares.

Example 18.5

Kotlas Limited has the following summarised balance sheet:

	£
Net assets	1250
Share capital – £1 shares	1000
Distributable profits	250
	1250

It purchases 200 £1 shares at a cost of £300. In the absence of a share premium account or a new issue of shares at a premium, the amount of the premium payable must be provided from distributable profits.

The permissible capital payment is:

	£
Amount payable	300
less Distributable profits	250
Permissible capital payment	50

As the permissible capital payment (£50) is less than the nominal value of the shares purchased (£200) it is necessary to make a transfer from distributable profits to a capital redemption reserve.

	£
Nominal value of shares purchased	200
less Permissible capital payment	50
Necessary transfer	150

Necessary journal entries and the resulting summarised balance sheet are given below:

	£	£
Dr Share capital	200	
Premium on purchase	100	
Cr Cash		300
	300	300
Dr Distributable profits	250	
Cr Premium on purchase		100
Capital redemption reserve		150
	250	250

Summarised balance sheet after purchase of shares

	£
Net assets (1250 – 300)	950
Share capital (1000 – 200)	800
Capital redemption reserve	150
(Permanent capital)	950

The permanent capital of the company has been reduced from £1000 share capital to £950. It has fallen by the amount of the permissible capital payment.

Example 18.6

Nordvik Limited has the following summarised balance sheet:

	£
Net assets	1250
Share capital – £1 shares	1 000
Share premium	200
(Permanent capital)	1200
Distributable profits	50
	1 250

Of the £1 shares, 500 were issued at par when the company was formed and 500 were issued at a premium of 40p per share some years later.

Nordvik purchases 200 of the shares, which were originally issued at par for an agreed price of £300, and finances the purchase in part by an issue of 50 shares at a premium of 60p per share.

As the shares purchased were not originally issued at a premium, no part of the premium payable may come from the proceeds of the new issue. The whole of the premium payable, that is the whole of the increase in value of these particular shares since their issue, must be charged against distributable profits.

In this case, the permissible capital payment is:

	£	£
Amount payable		300
less Distributable profits	50	
Proceeds of new issue (50 × £1.60)	80	130
Permissible capital payment		170

In order to determine whether or not a transfer to capital redemption reserve is necessary, we must compare the proceeds of the new issue and the permissible capital payment with the nominal value of the shares purchased.

	£	£
Nominal value of shares purchased		200
less Permissible capital payment	170	
Proceeds of new issue	80	250
		(50)

In this case no transfer to capital redemption reserve is required. Rather the excess £50 may be charged to one of the accounts discussed above and we have chosen to debit it to the share premium account.

Necessary journal entries and the resulting summarised balance sheet are given below:

	£	£
Dr Cash	80	
Cr Share capital		50
Share premium		30
	80	80
Dr Share capital	200	
Premium on purchase	100	
Cr Cash		300
	300	300
Dr Distributable profits	50	
Share premium	50	
Cr Premium on purchase		100
	100	100

Summarised balance sheet after purchase of shares

	£
Net assets (1250 + 80 – 300)	1030
Share capital (1000 + 50 – 200)	850
Share premium (200 + 30 – 50)	180
(Permanent capital)	1030
Distributable profits	–
	1030

The permanent capital of the company has been reduced from £1200 to £1030 by the amount of the permissible capital payment of £170.

Further safeguards

In view of the fact that there is a reduction in the permanent capital, that is a reduction in the net assets available to creditors and the remaining shareholders, the law provides a number of safeguards where a company wishes to make such a purchase of shares involving a payment out of capital. Thus, not only must the payment out of capital be permitted by the company's articles of association and authorised by a special resolution of the company, but the directors must also provide a statutory declaration of solvency to the effect that, having made a full enquiry into the affairs and prospects of the company, they have formed the opinion that the company will be able to pay its debts both immediately after the payment and during the following year. As the protection of creditors and shareholders rests on this continuing solvency of the company, the law requires that a report by the company's auditors on the reasonableness of the directors' opinion is attached to the statutory declaration.

After the payment out of capital has been authorised, the company must publicise it in an official gazette and either a national newspaper or by individual notice to each creditor. Any creditor, or any shareholder who did not vote for the special resolution, may then apply to the court for the cancellation of the resolution and the court may then cancel or confirm the resolution and may make an order to facilitate an arrangement whereby the interests of dissenting creditors or members are purchased.

If the directors' optimism subsequently proves not to have been well founded and the company commences to wind up within a year of the payment out of capital and is unable to pay all its liabilities and the costs of winding up, then directors and past shareholders may be liable to contribute. The directors who have signed the statutory declaration and/or past shareholders, whose shares were purchased, may have to pay an amount not exceeding in total the permitted capital payment.

Thus the Companies Act 1985 provides safeguards to protect creditors. The use of its provisions to make a purchase of shares partly out of capital is undoubtedly much cheaper and less burdensome than a reduction of capital under the provisions to which we turn next.

Capital reduction

There are other sections of the Companies Act 1985 that give companies much wider powers to reduce capital than that discussed above, but the Act imposes more onerous conditions if these powers are exercised, including the need to obtain the confirmation of the court.[6]

Provided it is authorised to do so by its articles of association, a limited company may reduce its share capital by passing a special resolution, which must be confirmed by the court. The Act gives a general power to reduce share capital but specifically lists three possible ways to reduce capital:[7]

(a) extinguish or reduce the liability on any of its shares in respect of share capital not paid up; or
(b) either with or without extinguishing or reducing liability on any of its shares, cancel any paid-up share capital which is lost or unrepresented by available assets; or
(c) either with or without extinguishing or reducing liability on any of its shares, pay off any paid-up share capital which is in excess of the company's wants.

Capital reductions for the first and third of the possible reasons listed are extremely rare. With regard to the first, few companies now have partly paid shares in existence and hence there is seldom any liability in respect of partly paid capital which could be reduced. With regard to the third, although it might make good economic sense for directors to return 'permanent' capital to shareholders where better investment opportunities exist outside the company than within it, most directors have been loath to relinquish their control over such resources and have usually found some way to employ them within the company.

Both of these capital reductions ((a) and (c)) do, of course, result in a reduction in the potential net assets or actual net assets available to creditors. Thus, in the first case, there is a reduction in the liability of members and hence in the potential pool of net assets available to creditors on a liquidation. In the third case, resources actually leave the company, so directly reducing the pool of net assets to which the creditors have recourse. For these reasons the court must give any creditor an opportunity to object to the capital reduction and will usually only confirm the scheme if the debt of such a dissenting creditor is paid or secured.

---

[6] As we shall see later in this chapter, the White Paper, *Modernising Company Law* (July 2002), proposes the introduction of an additional, simpler procedure based on the issue of a solvency statement by a company's directors.

[7] Companies Act 1985, s. 135.

The second of the three possible capital reduction schemes is the one most commonly found in practice. Thus, where a company has made losses in excess of previous profits, its net assets will be lower than its permanent capital. Given that such a position has been reached, it will often be sensible to recognise the fact by reducing the capital and writing off the losses so that a more realistic position is shown by the balance sheet and the company is allowed to make a fresh start. In particular, after such a scheme the company will be able to distribute realised profits without the need to first make good the accumulated realised losses and, in the case of a public company, net unrealised losses.[8]

The simplest way of carrying out such a capital reduction scheme is to reduce proportionately the nominal value of the ordinary shares outstanding. This has no effect whatsoever on the real value of the ordinary shareholders' interest since the same number of shares in the same company are held in the same proportions by the same people! Each shareholder has the same proportional interest in the net assets of the company after the scheme as before. This demonstrates the irrelevance of the par value and supports the argument that companies should be permitted to issue shares of no par value.[9]

To illustrate such a scheme, let us look at an example.

Example 18.7

Perm plc has the following summarised balance sheet:

	£
Net assets	1200
Share capital	
1000 £1 ordinary shares, fully paid	1000
500 £1 10% preference shares, fully paid	500
	1500
Share premium	200
	1700
less Accumulated losses	500
	1200

The preference shares rank for dividend and repayment of capital in priority to ordinary shares. The company wishes to reduce its capital by an amount sufficient to remove the accumulated losses and to write down the net assets to a more realistic book value of £900. Thus it wishes to reduce permanent capital by £800, that is £(500 + (1200 – 900)).

For illustrative purposes we shall consider two possible capital reduction schemes, the first involving a reduction of ordinary share capital only and the second involving the reduction of both ordinary share capital and preference share capital.

---

[8] See Chapter 4.

[9] A government committee under the chairmanship of Mr Montague Gedge reported in favour of the issue of shares of no par value as long ago as 1954, Cmnd. 9112/5, HMSO, London, 1954. Similar proposals in favour of no par value shares have been made in various consultation documents of the Company Law Review Steering Group, but the White Paper, *Modernising Company Law* (2002), recognises that, because the EU Second Directive (77/91/EEC [1977] OJ L26/1) requires public companies to have shares with a par value, the movement towards shares of no par value can only be a long-term aim!

Scheme 1

As explained above, the total amount of the capital reduction is £800. However, for the purpose of a reduction of capital, a share premium account is to be treated as paid-up share capital of the company[10] so that £200 may be written off against the share premium, leaving £600 to reduce the ordinary share capital from £1000 to £400, that is from £1 to 40p per share.

The balance sheet after the capital reduction would therefore appear as follows:

Summarised balance sheet after capital reduction

	£
Net assets	900
Share capital	
1000 40p ordinary shares	400
500 £1 10% preference shares	500
	900

The interest of preference shareholders and ordinary shareholders in the liquidation value of the company has not altered. Preference shareholders would receive the first £500 while ordinary shareholders would receive the remainder. If the company continues to trade, both sets of shareholders gain, in the sense that the company will be able to pay dividends as soon as profits are made without any need to make good the past losses.

Scheme 2

Given the fact that preference shareholders as well as ordinary shareholders benefit from the capital reduction scheme, ordinary shareholders might argue that preference share capital as well as ordinary share capital should be reduced. However, as we shall see, a reduction in the par value of a preference share has a much more serious effect than the reduction in the par value of ordinary shares. Indeed, a reduction in the par value of both preference shares and ordinary shares, with no other changes, will lead to a fall in the real value of the preference shares but a rise in the real value of the ordinary shares. This may be illustrated as follows.

As before, let us assume that the amount of the capital reduction is £800 and that, of this, £200 may be written off against the share premium account, leaving £600 to be written off against share capital. Given that the ordinary share capital is £1000 and that the preference share capital is £500, it might be thought that the amount of £600 should be written off in the ratio 2:1 which would produce a balance sheet as follows:

Summarised balance sheet after capital reduction

	£
Net assets	900
Share capital	
1000 60p ordinary shares	600
500 60p 10% preference shares	300
	900

Although this may initially appear to be fair, a little thought will make it clear that the preference shareholders have been unfairly treated.

Given that the par value of a preference share determines the amount of the preference dividend and the amount which the preference shareholders receive on a liquidation, preference

[10] Companies Act 1985, s. 130(3).

shareholders will have suffered a real loss. They are worse off after the scheme than before. Conversely, the ordinary shareholders are better off. Not only would they receive more on an immediate liquidation, as less would be paid to the preference shareholders, but also they are likely to receive higher future dividends, as a lesser dividend would be paid to the preference shareholders.

Careful attention must be paid to the likely effect of reducing the par values of different types of share capital. A capital reduction such as Scheme 2 is unlikely to be acceptable to the preference shareholders unless they are given some other benefit, such as a holding of ordinary shares, which will give them an opportunity to share in any future prosperity.

The proposed simplification of capital reduction

As we have explained, the procedures for capital reduction contained in the Companies Act 1985 are rather cumbersome and, in particular, require the confirmation of the court, with its associated costs. Following recommendations of the Company Law Review Steering Group,[11] the White Paper, *Modernising Company Law*, issued in July 2002, makes proposals for companies to be permitted to reduce their capital without the need for confirmation of the court, provided that the directors of the company make a solvency statement. Draft clauses of these proposals are contained in the second volume of the White Paper.[12]

Under the proposals, both private and public limited companies would be permitted to reduce their share capital in any way by passing a special resolution. However, public companies would have to comply with publicity requirements to ensure that, as far as is possible, creditors are informed of the proposed reduction of capital. Creditors of the company would have six weeks from the date of the resolution to apply to the court for the resolution to be cancelled and the court would then either make an order cancelling the resolution to reduce capital or dismiss the creditor's application.

The crucial requirement of this new process is the solvency statement required of directors, which we have already met earlier in the chapter in connection with the purchase of shares out of capital by a private company. The draft clauses define the envisaged solvency statement as follows:[13]

> **In this Chapter 'solvency statement', in relation to a proposed reduction of share capital, means a statement that the directors –**
>
> **(a) have formed the opinion that, as regards the company's situation at the date of the statement, there is no ground on which the company could then be found to be unable to pay its debts; and**
> **(b) have also formed the opinion –**
> **(i) if it is intended to commence winding up the company within the year immediately following that date, that the company will able to pay its debts in full within the year beginning with commencement of the winding-up; or**
> **(ii) if it is not intended so to commence winding up, that the company will be able to pay its debts as they fall due during the year immediately following the date of the statement.**

---

11 The Group proposed the abolition of the requirement for confirmation by the court and its replacement by the requirement for a declaration of solvency in Chapter 5.4 of the Consultative Paper, *Modern Company Law for a Competitive Economy: The Strategic Framework*, Department of Trade and Industry, February 1999.

12 Cm. 5553-II, Part 3, Chapter 3, *Reduction of Share Capital*, Clauses 50–67.

13 Cm. 5553-II, Part 3, Chapter 3, Clause 63.

In forming their opinion, the directors must take into account all liabilities of the company, including contingent and prospective liabilities, and, where a statement is made without reasonable grounds, the directors are guilty of an offence for which a penalty will be specified.

Such an approach focuses on what is really important, namely the ability of the company to pay its debts in full. It would simplify the law and would remove the necessity to have the separate rules which enable a private company to purchase its shares out of capital, discussed earlier in this chapter.

The legal background to other reorganisations

We have looked in some detail at the ways in which a company may reduce its share capital under the provisions of the Companies Act 1985 and examined proposed changes to this approach. As we saw in the introduction to this chapter, there are many other ways in which a company may wish to reorganise its capital. For example, it may wish to alter the respective rights of different classes of shareholders, or, if it is in financial difficulties, it may need to reduce not only share capital but also the claims of creditors. In this section we look briefly at the legal background to such reorganisations.

First, it is necessary to clarify that although the term 'capital reduction' has a clear legal meaning, as discussed above, the terms 'capital reorganisation', 'capital reconstruction' and, indeed, 'scheme of arrangement' do not. These terms tend to be used interchangeably although there is, perhaps, a tendency to use the term 'capital reconstruction' for the more serious changes in capital structure; so in the final section of this chapter we look at a capital reconstruction scheme undertaken as an alternative to liquidation of the company. In the remainder of this section we will use the term reorganisation.

Any reorganisation which involves creditors will invariably be carried out in accordance with the procedures laid down in ss. 425–426 of the Companies Act 1985. These procedures are designed to protect the various parties involved by requiring court approval for the reorganisation. This sounds fine in theory but the courts have been reluctant to pass judgement on the economic merits and fairness of schemes and have tended to concern themselves with deciding whether the scheme satisfies the required legal formalities.[14]

Under ss. 425–426, the company applies to the court which will then direct meetings of the various parties affected to be held. The company must then send out details of the proposed scheme and, provided a majority agree – in number representing three-quarters in value of those attending the various meetings – and provided the scheme is sanctioned by the court, it will become binding on all parties once a copy is delivered to the Registrar of Companies.

Sometimes a reorganisation entered into in accordance with the above provisions will involve the transfer of the whole or part of an undertaking from one company to another. In such a case, s. 427 gives the court wide powers to make provision for the transfer of ownership of assets, liabilities, rights and duties to the transferee company.

The above provisions may be used to effect a reorganisation even where there is no change in creditors' rights. However, alternative procedures are available in such cases which do not involve the formality and expense of going to court. Thus, it may be possible to vary the rights of two or more classes of shareholders by merely holding separate class meetings

[14] See L.C.B. Gower, *Gower's Principles of Modern Company Law*, 6th edn, edited by Paul L. Davies, with a contribution by Dan Prentice, Sweet & Maxwell, London, 1997, Chapter 28.

and obtaining the necessary majority votes, although a dissenting minority is given a right to object to the variation in an application to the court.

Another possible means of reorganisation is provided by s. 110 of the Insolvency Act 1986. Under this section, once a voluntary liquidation of the company is proposed, the liquidator may be given authority to sell the whole or a part of the undertaking to another company in exchange for shares or other securities in that other company. Thus, where it is desired to change the rights of two or more classes of its shareholders, the company may be put into voluntary liquidation and a new company may be formed with the desired mix of various classes of shares. The business of the transferor company may then be sold to the new company in exchange for the new shares, which may then be distributed to the shareholders in the transferor company to achieve the desired change. This procedure is much simpler than the use of a scheme under ss. 425–427 of the Act.

Invariably taxation considerations will be extremely important in most capital reorganisations and, in view of the complexity of the tax legislation, specialist advice is almost always necessary.

Capital reconstruction

In this section we shall concentrate on the design and evaluation of a capital reconstruction scheme for a company which is in severe financial difficulties. It will be assumed that, in the absence of a capital reconstruction scheme, the liquidation of the company would be inevitable. This assumption will affect both the design of the scheme and the way in which it will be evaluated by the interested parties.

As the alternative source of benefits to interested parties is the amount receivable on liquidation, it is essential for us to recall the order in which the proceeds from the sale of assets must be distributed by a liquidator.

Distribution on liquidation

It is the duty of a liquidator to sell the assets of a company as advantageously as possible and to pay costs, creditors and shareholders in the following order:

1 Debts secured by a fixed charge. These must be paid out of the proceeds of sale of the particular assets. In practice a receiver will usually be appointed to sell the assets which are the subject of the charge, and to pay the secured creditors the amounts due to them.

It will rarely be the case that the proceeds of sale are exactly equal to the costs of the receiver and the amount of the debt. Any excess will be paid over to the liquidator of the company while, to the extent of any deficiency, the creditors are treated in the same way as other unsecured creditors.

2 Costs of the liquidation, in the order specified by law.

3 Preferential creditors. These are listed in Schedule 6 to the Insolvency Act 1986 and include income tax deducted from employees' emoluments under PAYE, value added tax, car tax, social security contributions, contributions to pension schemes and remuneration of employees. There are limits to each of these categories so, for example, PAYE is preferential to the extent of one year's deductions, value added tax to six months, social security contributions up to one year and remuneration of employees up to four months. To the extent that only a part of a debt is preferential, the remainder will be treated as an unsecured creditor.
4 Creditors secured by a floating charge.
5 Unsecured creditors, including the amounts mentioned in 1 and 3 above.
6 Shareholders of the company in accordance with their rights as laid down in the company's articles of association. Preference shares will normally be paid before any amounts are paid to ordinary shareholders.

Where the amounts available are insufficient to pay any of the above groups in full, each member of the particular group receives the same proportion of the amount of his debt. This proportion is determined as the amount available for a particular group divided by the total amounts due to that group.

Design of a capital reconstruction scheme

Where a company is in financial difficulties, the objective in the design of a capital reconstruction scheme will be to produce an entity which is a profitable going concern. In some cases the financial difficulties may be so severe that this is impossible for, no matter how skilfully a capital reconstruction scheme is designed, it is not possible to turn the sow's ear into a silk purse. Where the financial difficulties are less severe and the company is capable of operating profitably, a capital reconstruction scheme may have a high probability of success. In order to achieve that success, it will usually be necessary to relieve the company of its burden of immediate debts and will often be necessary to raise new finance, probably by a new issue of shares.

Any capital reconstruction scheme which affects the rights of creditors and shareholders will require the necessary majorities of votes in favour of the scheme as required by s. 425 of the Companies Act 1985, together with the sanction of the court. Hence, to stand any chance of success, the scheme must give each interested party the same amount as or more than they would receive on liquidation of the company. In addition the scheme must be accepted as equitable by the various interested parties. It must ensure that no one class of creditor or shareholder is favoured at the expense of any other, so that all creditors and shareholders are treated – and feel that they are treated – fairly.

The design of a capital reconstruction scheme is illustrated in the following example, and the resulting scheme is evaluated in the final section of this chapter.

Example 18.8

A summarised balance sheet of Sakhalin plc on 31 December 20X1 is as follows:

Sakhalin plc
Balance sheet on 31 December 20X1

	£000	£000
Fixed assets at cost less depreciation		
Land and buildings	2500	
Plant and machinery	1000	3500
Current assets		
Stock and work-in-progress	1000	
Sundry debtors	1500	2500
		6000
less Current liabilities		
Bank overdraft	3000	
Trade creditors	1000	
Arrears of debenture interest	250	4250
		1750
Financed by		
10% secured debentures (note (a))		1250
1 million authorised and issued £1 5% cumulative preference shares	1000	
2 million authorised and issued £1 ordinary shares	2000	
	3000	
less Accumulated losses	2500	500
		1750

The following information is available:

(a) The debentures are secured on the office premises, the net realisable value of which is estimated to be £900 000.

(b) The other land and buildings are estimated to have a net realisable value of £1 900 000.

(c) The net realisable value of the plant and machinery is estimated to be £500 000, of the stock and work-in-progress £750 000, and the recoverable debts are now estimated to be £1 425 000.

(d) The preference dividend has not been paid for four years.

(e) The debenture interest is two years in arrears.

(f) The articles provide that, on liquidation, the preference shareholders rank for repayment at par prior to any distribution to the ordinary shareholders.

From preliminary meetings of the directors and soundings of the interested parties the following information has also been obtained:

(g) The debenture holders are prepared to agree to a reconstruction scheme, provided the rate of interest is increased from 10 to 15 per cent p.a., and they are given a fixed security on the total land and buildings, rather than just the office premises, of the company. They are also willing to accept ordinary shares in lieu of £125 000, that is one of the two years' interest in arrears.

(h) The bank is prepared to agree to a reconstruction scheme provided its debt is secured by a floating charge over the assets of the company, thus improving its position *vis-à-vis* any other creditors of the reconstructed company. They would be willing to provide the same amount of finance for the medium term.

(i) The trade creditors are unlikely to agree to any reduction in their claims but are thought to be willing to supply the reconstructed company and to continue to grant credit on normal terms.

(j) The preference shareholders would be willing to forgo their arrears of dividend and to accept ordinary shares instead of preference shares.

(k) The directors consider that, if the company is able to raise an additional £1 million in cash by a rights issue, it will be able to commence trading successfully. Expected annual earnings before debenture interest and dividends will then be at least £300 000 and, due to accumulated tax losses, no corporation tax will be payable in the foreseeable future.

(l) Debenture holders, preference shareholders and ordinary shareholders are willing to subscribe for new ordinary share capital in the company.

(m) Costs of the reconstruction scheme are expected to be £60 000.

(n) In the absence of a satisfactory scheme the company will have to be liquidated involving costs of £295 000.

From the above information it is possible to calculate the amount of the capital reduction required, namely:[15]

	£000
(a) To correct the value of plant and machinery	500
(b) To correct the value of stock and work-in-progress	250
(c) To correct the value of debtors	75
(d) To eliminate the adverse balance on the profit and loss account	2500
(e) To provide for the costs of the scheme	60
	3385
(f) Less surplus on revaluation of land and buildings	300
	3085

In order to begin to decide who must bear this loss in the reconstruction scheme, we must first examine what each class of creditor and shareholder would receive if the company were to be liquidated.

[15] In a balance sheet, assets should be shown at their 'going concern value' rather than their net realisable value. In order to avoid complicating the example by the introduction of another set of values, the realistic going concern values, assets have been written down to their net realisable values.

The realisable value of the assets and the way in which they would be distributed are as follows:

	£000	£000
Office premises	900	
less Payable to debenture holders		
secured on office premises	900	–
Other premises		1900
Plant and machinery		500
Stock and work-in-progress		750
Sundry debtors		1425
		4575
less Costs of liquidation		295
Available for unsecured creditors		4280
Unsecured creditors:		
Bank overdraft		3000
Debenture holders		
Capital	1250	
Interest	250	
	1500	
less Paid out of security as above	900	600
Trade creditors		1000
		4600

For simplicity it is assumed that there are no preferential creditors.

There would be £4280 available to meet unsecured creditors of £4600 with the result that each of these creditors, including the debenture holders to the extent that they are unsecured, would receive 93p in the £1. The various parties would therefore receive the following amounts on liquidation of the company:

	£000
Bank (0.93 × £3 000 000)	2790
Debenture holders (900 000 + 0.93 × 600 000)	1460
Trade creditors (0.93 × 1 000 000)	930
Preference shareholders	0
Ordinary shareholders	0
	5180

Thus all parties would lose on a liquidation and there is an incentive for them to agree to a suitable reconstruction scheme. It is clear that any losses under the scheme must fall most heavily on the shareholders.

One possible scheme of reconstruction would be as follows:

		Reduction £000
(a)	2 million £1 ordinary shares each to be reduced to 1p ordinary shares	1980
(b)	1 million £1 preference shares to be cancelled in exchange for 1 million 1p ordinary shares	990
(c)	The granting of an increased rate of interest of 15 per cent p.a. and a fixed charge on all premises to the debenture holders and the waiving of £125 000 of interest in arrears in exchange for 1 million 1p ordinary shares (£10 000)	115
(d)	The granting of a floating charge on the debt due to the bank	–
(e)	Consolidation of the 4 million 1p ordinary shares into 40 000 £1 ordinary shares	–
(f)	The making of a rights issue of 25 £1 ordinary shares for each £1 ordinary share held, thus raising cash of £1 000 000. Thus finance would come from old ordinary shareholders (£500 000), old preference shareholders (£250 000) and old debenture holders (£250 000)	–
Total reduction achieved as required		3085

After such a reconstruction scheme is carried into effect, the balance sheet would appear as shown below:

Sakhalin plc
Balance sheet after scheme

	£000	£000
Tangible fixed assets – at valuation		
Land and buildings		2800
Plant and machinery		500
		3300
Current assets		
Stock and work-in-progress	750	
Debtors	1425	
Cash	1000	
	3175	
less Current liabilities		
Bank overdraft (secured)	3000	
Debenture interest (1 year)	125	
Trade creditors	1000	
Cost of reconstruction	60	
	4185	(1010)
		2290
less 15% Debentures (secured on land and buildings)		1250
		1040
Share capital		
1 040 000 £1 ordinary shares, fully paid		1040

Note: The apparently poor current ratio is due to the fact that the bank overdraft is included in current liabilities, in accordance with normal practice, whereas it is in fact medium-term capital.

Evaluation of a capital reconstruction scheme

In evaluating a capital reconstruction scheme, as in designing it, the aim must be to establish the relative fairness of the changes in rights as a result of the scheme. In most cases, professional advisers are called upon by each class of member and creditor to evaluate the scheme from their point of view and, in order to do this, it is necessary to evaluate the scheme as a whole since the changes of relative rights will be extremely important.

The rights of participants fall into two classes: the capital repayment rights and the income participation rights. In order to make an appropriate comparison of these, it is helpful to set out the interest of the various parties in the company both before and after the proposed reconstruction.

In Example 18.9 we shall do this in respect of the scheme which has been proposed for Sakhalin plc in Example 18.8.

Example 18.9

Table 18.1 summarises the interests of the relevant parties before and after the scheme.

Table 18.1 Evaluation of proposed scheme – comparison of interests

Original class	*Interest prior to scheme*	*Interest after scheme*
Bank	£3 000 000 unsecured overdraft	£3 000 000 secured overdraft
Debenture holders	£1 250 000 partly secured 10% debentures *plus* £250 000 arrears of interest	£1 250 000 fully secured 15% debentures *plus* £125 000 arrears of interest *plus* one-quarter of the ordinary shares
Trade creditors	£1 000 000 unsecured debt	£1 000 000 unsecured debt
Preference shareholders	£1 000 000 £1 5% preference shares	One-quarter of the ordinary shares
Ordinary shareholders	All ordinary shares	One-half of the ordinary shares

We have already considered the amounts each class would receive should the scheme be rejected and the company forced into an immediate liquidation. These amounts need to be compared with the position following the reconstruction and we shall do so by evaluating three alternative possible outcomes. First, we shall assume that, despite the scheme, the company goes into liquidation immediately following the end of the capital reconstruction. Second, we will assume that the earnings are as expected, about £300 000 per annum. Finally, we will assume that the earnings are more than anticipated; we will, for this purpose, assume a figure of £500 000 per annum.

If we assume that the costs of the reconstruction scheme are paid, the position on the subsequent liquidation would be as follows:

Position on liquidation after scheme

	£000	£000
Amount receivable from sale of premises		2800
less Debentures		
Capital	1250	
Interest	125	1375
		1425
Amount realised from other assets		
Plant and machinery	500	
Stock and work-in-progress	750	
Debtors	1425	2675
Cash (1 000 000 – 60 000)		940
		5040
less Costs of liquidation		295
		4745
less Bank secured by floating charge		3000
		1745
less Trade creditors		1000
Available for ordinary shareholders		745
Divisible:		
Old debenture holders $\left(\frac{1}{4}\right)$		186
Old preference shareholders $\left(\frac{1}{4}\right)$		186
Old ordinary shareholders $\left(\frac{1}{2}\right)$		373
		745

So, on a liquidation subsequent to the scheme the original parties would receive the following amounts:

	£000
Bank	3000
Debenture holders (1 375 000 + 186 000)	1561
Trade creditors	1000
Preference shareholders	186
Ordinary shareholders	373
	6120

Debenture holders and preference shareholders have, of course, subscribed £250 000 each for new ordinary share capital while ordinary shareholders have subscribed £500 000.

Let us next examine the interests of the various parties in the expected earnings of the reconstructed company.

As we have seen in note (k) on p. 599, the annual earnings before debenture interest and dividends are expected to be at least £300 000 and no corporation tax is likely to be paid in the foreseeable future. It follows that these earnings may be divided as shown:

	£	£
Old debenture holders		
Interest 15% × £1 250 000	187 500	
Share of balance $\frac{1}{4}$ (300 000 – 187 500)	28 125	215 625
Old preference shareholders		
$\frac{1}{4}$ (300 000 – 187 500)		28 125
Old ordinary shareholders		
$\frac{1}{2}$ (300 000 – 187 500)		56 250
		300 000

It is helpful to examine the position if earnings turn out to be higher or lower than expected and, for illustrative purposes, we look at the position if earnings are £500 000:

	£	£
Old debenture holders		
Interest – as above	187 500	
Share of balance $\frac{1}{4}$ (500 000 – 187 500)	78 125	265 625
Old preference shareholders		
$\frac{1}{4}$ (500 000 – 187 500)		78 125
Old ordinary shareholders		
$\frac{1}{2}$ (500 000 – 187 500)		156 250
		500 000

We are now able to set out in Table 18.2 the position of each party before and after the proposed scheme in order to draw conclusions about its acceptability.

Table 18.2 Positions of parties before and after proposed scheme

			Position after scheme		
Original class	*Amount receivable on liquidation before scheme*	*New capital introduced*	*Amount receivable on liquidation after scheme*	*Share of earnings £300 000*	*Share of earnings £500 000*
	£000	£000	£000	£000	£000
Bank	2790	–	3000	n/a	n/a
Debenture holders	1460	250	1561	215.625	265.625
Trade creditors	930	–	1000	n/a	n/a
Preference shareholders	–	250	186	28.125	78.125
Ordinary shareholders	–	500	373	56.250	156.250

The scheme would appear to offer advantages to all parties:

The bank converts unsecured debt into secured debt and stands to receive more in a liquidation after the scheme than in one before it.

On an immediate liquidation the debenture holders would receive £1 460 000, whereas if they invest a further £250 000 they will obtain a higher rate of interest on their debentures, a higher level of security and one-quarter of the ordinary shares in the reconstructed company. Although they would only receive £1 561 000 on a liquidation after the scheme, their share in future earnings is attractive. If the level of future earnings is £300 000 their rate of return is approximately 12.6 per cent, that is £215 625 divided by the amount of £1 710 000 (1 460 000 + 250 000) effectively invested. If future earnings are £500 000, the rate of return rises to approximately 18.2 per cent.

Trade creditors would receive more in a liquidation after the scheme than in one before it.

Both preference shareholders and ordinary shareholders would appear to benefit considerably from the scheme. Although they would not receive back their new investment if a liquidation occurred immediately after the scheme, their potential earnings yield is high. If future earnings are £300 000, the yield is 11.25 per cent (28.125/250) while, if earnings are £500 000, the yield rises to 31.25 per cent (78.125/250).

If all the parties are happy with the scheme, they will vote in favour of it at their respective meetings. Provided it is then confirmed by the court, the scheme will become operative as soon as a copy of the court order is lodged with the Registrar. If any of the parties are unhappy with the scheme, it will be necessary to amend it. If, at the end of the day, agreement on a satisfactory scheme cannot be reached, the company will be liquidated.

Summary

In this chapter, we have looked at the rather complex topics of capital reorganisation, reduction and reconstruction.

We started by looking at the rules governing the purchase by a company of its own shares. While both private and public companies are permitted to purchase their own shares for cancellation, only a private company is permitted to purchase its own shares out of capital. We have illustrated the legal rules and seen that the application of these rules does not always achieve what appears to be the intended purpose of the law.

We have next looked at the wide-ranging power of companies to reduce their capital subject to the confirmation by the court and illustrated how this may be done. The involvement of the court brings with it substantial costs and we have outlined the proposals, made in the White Paper, *Modernising Company Law*, to simplify company law in this area. Under these proposals, both private and public companies would be able to reduce capital in any way by passing a special resolution, provided that the directors make a 'solvency statement'.

We have outlined the legal background to other reorganisations and finished the chapter with an examination of capital reconstruction schemes. Here we have illustrated the principles involved in both designing such a scheme and evaluating a scheme on behalf of the various parties who may be affected by it.

Recommended reading

J.H. Farrar, N.E. Furey, B.M. Hannigan and O.P. Wylie, *Farrar's Company Law*, 4th edn, Butterworths, London, 1998.

L.C.B. Gower, *Gower's Principles of Modern Company Law*, 6th edn, P. L. Davies (ed.) with a contribution from D. Prentice, Sweet & Maxwell, London, 1997.

T. Johnson, *A private company's purchase of own shares*, Butterworths, London, 1997.

M. Wyatt, *Company Acquisition of Own Shares,* 4th edn, Financial Times Pitman Publishing, London, 1995.

M. Wyatt, 'Purchase of own shares', *Accountants Digest*, No. 376, ICAEW, London, 1997.

A useful website

www.dti.gov.uk/companiesbill

Questions

18.1 In recent years several large listed companies have purchased their own ordinary shares.

You are required to summarise:

(a) **the accounting requirements for a public listed company when it purchases its own shares;** (9 marks)

(b) **six advantages of a company purchasing its own shares.** (6 marks)

CIMA, Advanced Financial Accounting, November 1991 **(15 marks)**

18.2 H plc was established in 1996 to develop advanced computer software. The company was established with the financial backing of B Bank. B Bank invested £2 million in H plc's share capital, buying 2 million £1 shares at par. The agreement was that B Bank would leave this investment in place for five years. At the end of that period, H plc would buy the shares back from B Bank at a price that reflected the company's success during that period.

An independent accountant advised that B Bank's 2 million shares in H plc were worth £4.5 million. The shares were repurchased on 30 April 2001 for that amount.

H plc's balance sheet immediately before the repurchase was as follows:

H plc

Balance sheet at 30 April 2001 (before share repurchase)

	£ million
Net assets	18.0
Share capital	7.0
Profit and loss	11.0
	18.0

The net assets figure includes £8.0 million cash.

Required:

(a) **Prepare H plc's balance sheet as it would appear immediately after the share repurchase.** (5 marks)

(b) **When a company repurchases its shares, it must normally make a transfer from its profit and loss account to its capital redemption reserve (CRR). It has been suggested that this transfer is necessary to protect the company's lenders. Explain how the transfer to the CRR protects the interests of lenders when a company repurchases its shares.** (10 marks)

(c) **Explain why companies are permitted to buy back their own shares.** (5 marks)

CIMA, Financial Accounting – UK Acounting Standards, May 2001 **(20 marks)**

18.3 Capital plc carried on business in four product segments, namely aircraft design, hairdressing salons, import agencies and beauty products.

The directors are now considering the dividend policy and the future capital structure of the company.

The draft accounts of Capital plc as at 30 November 1995 showed the following share capital and reserves:

Share capital		£m
Ordinary shares of £1 each	*Note 1*	500
8% Redeemable preference shares of £1 each	*Note 2*	50
Reserves – all credit balances		
Share premium		63
Capital redemption reserve		10
Fixed asset revaluation reserve	*Note 3*	43
Profit and loss account	*Note 4*	775

Note 1
The market value of ordinary shares as at 30 November 1995 was £1.60.

Note 2
The redeemable preference shares were issued in 1985. They are redeemable at par.

Note 3
A revaluation reserve of £45 million was created on 1 December 1994 on the revaluation of some of the buildings. A debit of £2 million was made to the reserve in 1995 arising from a permanent fall in value on the revaluation of certain computer equipment.

Note 4
The profit and loss account of Capital plc for the year ended 30 November 1995 contained the following items:

(i)	Exchange gain on a long-term German mark loan taken out on 1 December 1994	£6m
(ii)	Depreciation based on historic cost of fixed assets	£68m
	Additional depreciation based on revalued amount of fixed assets	£13m
(iii)	Development costs for the year written off	£22m
(iv)	Profit attributed to long-term contracts in beauty products	£9m

At their next meeting the directors will be considering proposals for:

(a) the purchase 'off market' at £1.50 per share of 30% of the issued ordinary shares of Capital plc which are currently held by Venture plc, a venture capital company. The directors consider that the shares are substantially undervalued and that the company should purchase the shares and hold them as an investment classified under 'own shares' in the balance sheet;

(b) the redemption of the preference shares;

(c) the distribution to the shareholders of Capital plc of shares in Kind plc, which have been held as an investment. The investment appears at cost, £15 million, in the balance sheet and the directors estimate that it has a market value of £24 million at 30 November 1995;

(d) a bonus issue of one ordinary share for every 20 ordinary shares held; and

(e) the amount of the final dividend to recommend for 1995.

The finance director has been requested to present a report in relation to these proposals.

Required
(a) (i) **Advise the board on its proposed procedure for purchasing the issued shares in Capital plc held by Venture plc and on its intention to hold these as an investment.**
(ii) **Draft the journal entries to record the purchase transaction assuming that the board acts in accordance with the requirements of the Companies Act 1985.** (4 marks)

(b) (i) **Explain the definition of distributable profits in a public company (ignore the rules relating to investment companies).**
(ii) **Identify which of the proposals (a) to (e) above would be classified as a distribution.**
(iii) **Describe the accounting treatment of proposal (c), distribution of shares held as an investment in Kind plc.** (5 marks)

(c) **Calculate the distributable profits as at 30 November 1995 on the assumption that the company had redeemed the preference shares and made the bonus issue but delayed action on the purchase of own shares and the distribution of the shares in Kind plc until 1996. Explain clearly your treatment of each item mentioned in the reserves.** (11 marks)

ACCA, Financial Reporting Environment, December 1995 **(20 marks)**

18.4 Renewal plc was incorporated in 1985 to carry on business as manufacturers of designer jewellery. The company has incurred recent trading losses but has now returned to modest profitability. The directors estimate that raising new capital for additional investment in plant would produce an increase in profit from £1 000 000 to £1 750 000 per year but in order to be able to pay dividends it it necessary to eliminate the debit balance on the profit and loss account.

The balance sheet of Renewal plc as at 31 May 1996 showed:

	£000	£000	£000
Capital and reserves			
Ordinary shares of £1 each – 80p paid up			4080
8% cumulative preference shares of £1 each			5440
Profit and loss account balance			(5046)
Profit attributable to arrears of preference dividends			1306
			5780
Fixed assets			
Freehold premises			2890
Plant and machinery			2040
Patents			578
Development expenditure			408
Current assets			
Stock	2108		
Debtors	2720		
		4828	
		4828	5916
Current liabilities; amounts due in less than one year			
Trade creditors	2176		
Overdraft	1768		
Loans from directors	1020		
		4964	
Net current liabilities			(136)
			5780

The directors have formulated the following scheme:

(a) The unpaid capital on the £1 ordinary shares to be called up.

(b) The ordinary shareholders to agree to a reduction of 70p on each share held with new shares having a nominal value of 50p and treated as 30p paid up.

(c) The preference shareholders to agree to the cancellation of their three years' arrears of dividend.

(d) The preference shareholders to agree to a reduction of 20p on each share held with the new shares having a nominal value of 80p and treated as fully paid up.

(e) The dividend rate on preference shares to be increased from 8% to 11%.

(f) The debit balance on the profit and loss account to be eliminated.

(g) Freehold premises have been professionally valued at £3 800 000.

(h) Plant is to be written down by £850 000; patents are to be written down to £340 000; development expenditure is to be written off; stock is to be written down by £406 000; a provision for doubtful debts of 10% is to be created.

(i) New capital to be raised by a rights issue with existing ordinary shareholders subscribing for two shares for every one share held, 30p payable on application, and preference shareholders subscribing for one new 80p preference share for every four preference shares held.

(j) The directors to agree to £420 000 of their loans to be written off and to accept ordinary shares of 50p each, at a value of 30p (paid up), in settlement of the balance of their loans. These shares are not affected by the rights issue in (i) above.

Required

(a) (i) Explain the procedure that a company needs to follow to readjust the rights of members under ss. 425 and 426 of the Companies Act 1985.

(ii) Advise the directors on an altemative course of action if the ordinary shareholders are not prepared to accept new obligations arising from the proposal to issue partly paid shares. (5 marks)

(b) Prepare the balance sheet for Renewal plc on the assumption that the directors' scheme has been put into effect. (7 marks)

(c) Advise the preference shareholders whether they should participate in the scheme. (8 marks)

ACCA, Financial Reporting Environment, June 1996 **(20 marks)**

18.5 The Collapsible Chair Company Limited was incorporated in 1972 and traded profitably until the 1990s. During the early 1990s the entry of new competitors into the market led to a fall in demand for its product. Consequently, the company started making losses and no dividend has been paid to its equity shareholders since 1992.

A significant failure to co-ordinate production and sales, and a breakdown in credit control following staff illness, has led to an increase in stock and debtors. This, in turn, has led to an increase in the bank overdraft beyond the current limit of £1.3 million. Discussions with the bank have revealed a reluctance to increase the overdraft limit beyond the current level. The debentures, all of which are held by the bank, are due for repayment on 31 December 1997. Both the debentures and the overdraft are secured by a fixed charge over the premises. The bank has threatened to put the company into receivership so as to recover the amounts owed to it. The costs of a receivership and likely subsequent liquidation are estimated at £150 000.

The directors of the company approached a venture capitalist with the idea of using a new design to produce an alternative type of chair. With an investment of £1.2 million, production could begin to yield an annual operating profit before debenture interest and taxation of £600 000 which would result in a cash inflow of a roughly equal amount. However, the venture capitalist was reluctant to invest in the company unless a scheme of capital reorganisation was agreed, and did not wish to gain a controlling interest in the company.

The balance sheet of the company at 31 March 1997, before the implementation of the capital reorganisation scheme, was as follows:

	£000	£000
Fixed assets:		
Premises	3000	
Plant	2000	
		5000
Current assets:		
Stocks	2000	
Debtors	1500	
	3500	
Current liabilities:		
Trade creditors	1800	
Bank overdraft	1500	
8% debentures	2500	
	5800	
Net current liabilities		(2300)
		2700
Capital and reserves:		
Equity share capital (£1 each)		6000
Profit and loss account		(3300)
		2700

The directors have obtained the following estimates for the value of the assets of the company as a going concern, and in a liquidation, at 31 March 1997.

Asset	*Going concern value*	*Liquidation value*
	£000	£000
Premises	3500	3500
Plant	1600	400
Stock	1500	500
Debtors	1300	900

A scheme of capital reorganisation has been agreed with all interested parties and implemented by the directors. Details of the scheme are as follows:

(1) The equity shares of £1 were redesignated as 30p shares.

(2) The assets of the company were stated at their going concern values.

(3) The repayment date for the debentures was deferred to 31 December 2007 with the interest rate increased to 10% per annum.

(4) The bank was issued with 1 million 30p equity shares in return for its willingness to accept a deferred repayment of the debentures.

(5) The venture capitalist subscribed for 4 million new 30p equity shares at par.

(6) The accumulated losses were written off.

Requirements

(a) **Prepare the balance sheet of the company at 31 March 1997 which incorporates the scheme which has been implemented.** (13 marks)

(b) **Assess the effect of the scheme from the point of view of EACH of**
- **the equity shareholders;**
- **the bank;**
- **the venture capitalist.** (12 marks)

CIMA, Financial Reporting, May 1997 **(25 marks)**

18.6 Medical Equipment plc was incorporated in 1970 to assemble medical equipment used in hospitals. The directors of the company had a major shareholding and were all engaged full time in the operational management of the company. The company had experienced operating losses and the directors believed that profit improvement depended on reducing labour costs. They accordingly decided to automate the assembly process by investing in the development of an automatic machine known as 'Auto-Assembler'.

The 'Auto-Assembler' was tested and developed in 1990 and by 31 December 1990 development expenditure of £157 300 incurred in the development of the 'Auto-Assembler' has been capitalised. It was estimated that its operational use would result in cost savings of £130 000 per annum before tax and that it could be made operational in 1991 for a capital outlay of £75 000. The directors had been building up a short-term investment during 1989–1990 to cover this capital outlay.

The production engineer estimated that as a result of automation an additional £40 000 investment would be required for working capital to meet the additional cost of higher specification materials.

In December 1990 the manager of the bank informed the directors that he wanted the overdraft reduced to around £75 000 from its present level of £270 480.

The directors immediately approached Mr Jeremiah, a partner in the accounting firm of Hard Reality & Co. who were the company's auditors. They believed in the potential profitability of the new automated assembly process and advised Mr Jeremiah that they believed that they would be able to negotiate long-term loan finance to clear the overdraft. At the request of the accountants the company produced the following:

(i) draft accounts as at 31 December 1990

(ii) additional information on assets and liabilities.

Draft profit and loss account for the year ended 31 December 1990

	£	£
Sales		2 008 000
Cost of sales		
Materials	1 398 800	
Labour	300 000	
		1 698 800
Gross profit		309 200
Distribution costs		(213 200)
Administration expenses		(129 000)
Profit before interest and tax		(33 000)
Interest		(51 600)
Profit before tax		(84 600)

Draft balance sheet as at 31 December 1990

	£
Fixed assets	
Freehold land and buildings	312 000
Plant and machinery	197 600
Development cost of 'Auto-Assembler'	157 300
	666 900
Current assets	
Stock	302 400
Investments	52 000
Debtors	169 000
Cash	2 600
	526 000
	1 192 900
Current liabilities	
Creditors	(303 240)
Overdraft	(270 480)
	(573 720)
Non-current liabilities	
10% debentures	(208 000)
Capital employed	411 180
Capital and reserves	
Ordinary shares of £1 each	425 000
Share premium account	42 500
7% non-cumulative preference shares of £1 each	260 000
Profit and loss account	(316 320)
	411 180

Additional information on individual assets and liabilities as at 31 December 1990:

	Going concern values assuming 'Auto-Assembler' does NOT become operational	*Going concern values assuming 'Auto-Assembler' DOES become operational*	*Values realisable on liquidation*
	£	£	£
Freehold land and buildings	385 000	385 000	385 000
Plant and machinery	123 500	88 400	44 200
Stock	292 400	254 800	200 100
Debtors	149 000	149 000	119 840
Investments	52 000	52 000	81 000
Development costs	–	157 300	–

The creditors comprised:	£
Preferential creditors	34 700
Loan interest accrued on debentures	10 400
Trade creditors	258 140
	303 240

Trade creditors allow 60 days' credit.

The debentures were secured on the freehold land and buildings and were redeemable at par in 1997.

Mr Jeremiah was not convinced that the directors would be able to arrange long-term loan finance to replace the overdraft and was of the opinion that a scheme of internal reconstruction would become necessary. He requested one of his staff to draft a brief report to explain to the directors feasible ways forward.

Required

(a) **Prepare a balance sheet as at 31 December 1990 on the basis that the company ceased trading on that date and explain its significance for the relevant parties.** (5 marks)

(b) (i) **Explain briefly the purposes of a scheme for reconstruction as it would apply to equity and loan stockholders.** (4 marks)

(ii) **Propose a scheme for the capital reconstruction of Medical Equipment plc. Show your calculation of the loss involved in the scheme; state what you would do with this loss; calculate the working capital requirements of the company; calculate the possible additional equity capital that might be required.**

Note: **The revised balance sheet after the implementation of the scheme is not required.** (16 marks)

(iii) **Explain briefly to the directors how the scheme will be fair to all relevant parties.** (5 marks)

ACCA, Advanced Financial Accounting, June 1992 **(30 marks)**

18.7 Aztec plc was incorporated in 1968 as an importer of silver artefacts from South America which it customised for the UK market. The company had sold its products in the luxury market and traded profitably until 1989. Since that date it has suffered continuous losses which have resulted in a negative balance on the profit and loss account. The balance sheet as at 31 December 1993 showed the following:

Share capital and reserves	£
Ordinary shares of 1 each	675 000
7% Preference shares of 1 each	135 000
Profit and loss account	(573 000)
Net capital employed	237 000
Fixed assets	
Leasehold premises	397 000
Vehicles and equipment	105 000
Machinery	250 000
Current assets	
Stock	295 000
Debtor	120 000
Current liabilities	
Suppliers	(288 000)
Wages VAT and PAYE	(80 000)
Hire-purchase liability on vehicles/equipment	(20 000)
Bank overdraft (secured by a fixed charge over the machinery)	(112 000)
Non-current liabilities	
Hire-purchase liability on vehicles and equipment	(25 000)
11% Debentures (secured by a floating charge)	(405 000)
Net assets	237 000

Since 1989 the company has been developing an export market for its products in Europe and the directors forecast that the company will return to profit in 1994. They expect profits before tax and debenture interest to be in the range of £70 000 to £140 000 per annum over the next three years. As a result of developing the export market, they expect that the company will require warehouse premises on the Continent in 1996 at a forecast cost of £250 000.

However, the directors are concerned that even if the company achieves a profit of £70 000 per year it will be a number of years before a dividend could be distributed to the ordinary shareholders and it would be difficult to raise fresh funds from the shareholders in 1996 if there were to be little prospect of a dividend until the year 2000.

The directors have been considering various possible courses of action available under the Companies Act 1985 and the Insolvency Act 1986 and have had initial discussions with their auditors.

As a result of these discussions it was agreed that the finance director would produce a draft proposal for reorganisation; the auditors would let the finance director have their comments on the draft proposal: and the finance director would then submit a proposal to the board of directors for their consideration.

The following additional information was obtained by the finance director concerning the assets and liabilities at 31 December 1993 and estimated costs of liquidating or reorganising:

(a) Fair values and liquidation values of assets were:

	Fair values on a going concern basis	*Liquidation values on a forced sale basis*
	£	£
Leasehold premises	360 000	100 000
Vehicles and equipment	85 000	35 000
Machinery	225 000	122 000
Current assets		
Stock	285 000	150 000
Debtors	110 000	100 000

(b) Preference dividends are four years in arrears.

(c) Wages, VAT and PAYE would be preferential creditors in a liquidation.

(d) The costs of liquidating Aztec plc were estimated at £55 000.

(e) The costs of reorganisation were estimated at £40 000; these would be paid by Aztec (Europe) plc and treated as part of the purchase consideration.

The finance director prepared the following draft proposal:

(i) A new company was to be formed, Aztec (Europe) plc with a share capital of £270 000 in 10p shares to acquire the assets and liabilities of Aztec plc as at 31 December 1993.

(ii) The ordinary shareholders were to receive less than 25% of the ordinary shares in Aztec (Europe) plc so that the existing preference shareholders and debenture holders each had a significant interest and acting together had control of the new company.

(iii) The arrears of preference dividends were to be cancelled.

(iv) The new company was to issue:
- 900 000 ordinary shares and £70 000 of 13% debentures to the existing preference shareholders;
- 1 200 000 ordinary shares and £200 000 of 13% debentures to the existing 11% debenture holders;
- 600 000 ordinary shares to the existing ordinary shareholders.

(v) The variation of the rights of the shareholders and creditors was to be effected under s. 425 of the Companies Act 1985 which requires that the scheme should be approved by a majority in number and 75% in value of each class of shareholders, by a majority in number and 75% in value of each class of creditor affected and by the court.

(vi) The transfer of the assets to Aztec (Europe) plc was to be effected under s. 427 of the Companies Act 1985 which would ensure that the court dealt with the transfer of the assets and liabilities and the dissolution of Aztec plc to avoid the costs of winding up that company.

Assume a corporation tax rate of 35% and an income tax rate of 25%. Ignore ACT.

Required

(a) **Assuming that the necessary approvals have been obtained for assets and liabilities to be transferred on the proposed terms on 31 December 1993:**
   (i) **Prepare journal entries to close the books of Aztec plc; and**
   (ii) **Prepare the balance sheet of Aztec (Europe) plc after the transfer of assets and liabilities.** (10 marks)

(b) **Draft a memo to the finance director commenting on his draft proposals for a scheme of capital reduction and reorganisation.** (16 marks)

(c) **Advise the directors as to the course of action they should take in order to be able to proceed with their plans for reorganisation if they learn that a creditor has obtained a judgment against the company and is considering seeking a compulsory winding-up order.** (4 marks)

ACCA, Financial Reporting Environment, June 1994 **(30 marks)**