An important aspect of capital maintenance law company business partnership essay...

Law

Length: wordsArticle: Capital Maintenance rules and their effectiveness as a form of creditor protection. Introduction: The concept of ‘ capital' has a restricted and technical meaning within company law. A company's capital adds up to all of the cash or the value of assets received by a company from investors in return for the company's shares. This is an important source of finance for companies1. This legal capital or equity raised by a company cannot be repaid unless in some circumstances2. The quintessence of the legal capital policy is that capital paid by shareholders and certain other reserves should not be paid back to them except in securely controlled circumstances. The widely used routes for return of capital are in the form of dividends, purchase or redemption of company’s shares or restructuring of company’s capital structure. An additional important source of financing for a company is debt or money contributed by the creditors. Capital Maintenance Rules were got in for two things: Creditor ProtectionShareholder ProtectionThe legal capital regime aims at creating some sort of balance between the rights of the shareholders and the rights of the creditors, the regulation of this interplay of interests is critical to the success of a company. This article will stress ore on the capital maintenance rules in relation to creditor protection. One of the first cases that highlighted the development of capital maintenance rules was Trevor v Whitworth3. Lord Herschell said the following: " 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 effect 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." What happened here was a zero sum game4; where a snake tries to swallow its own tail. To better understand the above situation what happened was that the company was trying to buy its own shares. In the balance sheet the share capital was on the liability side and the cash on the asset side. After this buyout the cash would be converted into investment in its own share capital at par value, thus squaring off the assets and liabilities side. Lord Watson said: " Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business." In the case what happened was that the company had to pay the shareholder; when he appealed to the court that as the company had bought back a quarter of its shares. Now during liquidation he had a right to ask for the payment of those shares. He claim had now become like that of a creditor. Therefore now a company may not purchase its own shares. Such a purchase would return

the seller of the shares the capital that has been paid up on the shares. 5The Act included two provisions of particular interest to the Lords. Firstly, there was a requirement that the company should specify its nominal capital6. Secondly, the Act provided for a comprehensive procedure for reducing ' capital' - the assets of the company7. The capital maintenance doctrine which the Lords recognised in Trevor v Whitworth was borne out of a concern for the position of creditors8 in the wake of the development of the concept of limited liability. As noted earlier in the wake of liquidation the creditor would be along the lines of the shareholder in demanding money back from the company. For the importance of creditor's interest it was thus important to preserve the asset base as much as possible. The courts and thereafter the legislature recognised that capital reduction was inconsistent with the concept of limited liability9. Creditor Protection: An important aspect of capital maintenance rule is creditor protection. Creditor protection rules create a barrier to retreat money from a company to creditor's disadvantage. They may also indicate how money should be put into a company, and pose minimum capital requirements. A certain amount of protection of creditor interests is adamant for their interest in supporting businesses, and ensures that their information on a company's situation remains reliable. However, many creditors still protect themselves the best by means of contract. 10The 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 losses11. As it is feasible that investment guiding principle harmful to the creditors will be pursued, or that

the borrowing will be extended, it is in any case worth restraining the scope of externally financed as well as liquidation-financed dividend payouts. Furthermore, equivalent asset transfers prior to 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. 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.