清华大学商法研究中心·编　　朱慈蕴·主编

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From Capital Requirements to Solvency Tests*

Wee Meng Seng**

On 28 December 2013, the Standing Committee of the People's Congress amended China's Company Law on the minimum capital requirements and the new law came into force on 1 March 2014. Before the amendment, a limited liability company was required to have a minimum registered capital of RMB 30,000, or where the company was wholly owned by one shareholder, a minimum registered capital of RMB 100,000. For a company limited by shares, the minimum registered capital was RMB 5 million. The amendment abolishes the minimum capital requirements, unless the State Council provides otherwise in the law, administrative regulations or decisions for companies in certain industrial sectors. The purposes of the amendments are, inter alia, to lower the threshold requirements for the formation of the companies and to encourage the public to invest in companies.

There has been a parallel movement in the liberalisation of capital requirements in several Commonwealth jurisdictions in the past decade. The purpose of this paper is to explain and critique how the law has evolved over the last one hundred plus years in England and a few of her former colonies. It is hoped that the lessons drawn may have some reference value for China.

This paper is based on Singapore law, but there will be substantial references to English law and New Zealand law. All references to statutory provisions are to Singapore's Companies Act (Cap 50, 2006 Rev Ed), otherwise unless indicated.

1. Minimum capital and capital maintenance

There are different ways in which capital may be used to protect creditors. The approach in civilian countries is to impose minimum capital requirements on their companies. English law has traditionally not used this method to protect the creditors of companies. Except in very limited industries, for example, banks and financial institutions, companies can be and frequently are formed with minimal capital.[①] However, although there is no minimum capital requirement, English law requires that whatever capital

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* This paper draws on an earlier article of the author: Wee Meng Seng, "Reforming Capital Maintenance Law: The Companies (Amendment) Act 2005" (2007) 19 Singapore Academy of Law Journal 295.

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① RP Austin & IM Ramsay (eds), *Ford's Principles of Corporations Law* (Lexis Nexis Butterworths, 13th Ed, 2007) [24.360].

that is subscribed cannot be reduced or returned to shareholders unless certain prescribed requirements are satisfied. This is called the capital maintenance doctrine.

Two reasons are usually given for rejecting a minimum capital requirement as a method of creditor protection.[②] First, the adequacy of the minimum capital figure must depend on the riskiness of the business which the company proposes to carry on, which varies from one business to another. If a single figure is prescribed, it is liable to be either too high or too low; whereas prescribing different figures for different businesses will be either too costly or unworkable in practice. Secondly, in any event, a minimum capital requirement does not guarantee that the capital subscribed will be intact to meet the claims of creditors after the company commences trading. It would achieve that result only if it is combined with a requirement that the company is required to top up loss capital or if it is unable or unwilling to do that, to cease trading or perhaps enter into an insolvency proceeding. But a company who has suffered a loss in capital may not be insolvent or suffering from financial difficulty, and the business it carries on may still be viable. To compel such a company to resort to those measures, instead of protecting creditors, may on the contrary be detrimental to them and also the employees and shareholders.[③]

2. Capital maintenance doctrine

Instead of using a minimum capital requirement to protect creditors, English law relied on the doctrine of capital maintenance. The starting point is that whatever capital that the shareholders of the company raised should not be returned to shareholders. This leads to other more technical rules, for example, the rule that the capital figures recorded on a company's balance sheet should not be reduced, the rule that a company is not allowed to buy back its own shares, etc.

(a) Inviolable fund concept-inception and qualification

The usual way of presenting the doctrine in textbooks is to refer to the leading cases and explain that capital could not be returned to shareholders without the leave of the court. In the leading case of *Trevor v. Whitworth*,[④] Lord Watson explained the doctrine and its rationale as follows:

"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."

Woon's Corporations Law explains that creditors rank ahead of members in a company's insolvent

② Paul Davies, *Introduction to Company Law* (2002) 85.

③ Ibid. 86.

④ (1887) LR 12 App Cas 409, 423 – 424 (emphasis added). An unlimited company may reduce capital by special resolution without seeking the court's confirmation; *Re Borough Commercial and Building Society* [1893] 2 Ch. 242.

liquidation. If capital is returned to the members, the effect would be to give them a preference over the creditors in the event of the company going into an insolvent liquidation. Thus the members are prohibited from getting back their capital while the company is a going concern and this is the opportunity cost of limited liability.

The doctrine, as explained by Lord Watson in the passage quote above, gives the impression that the capital of the company, in an abstract sense, constitutes a fund which creditors of the company rely upon when they give credit to the company, and thus capital is not allowed to be returned to the shareholders. However, the need for the ability to adjust a company's capital was felt early on. Twelve years after the introduction of limited liability companies, section 9 of the Companies Act 1867 introduced provisions permitting companies to reduce their capital.[5] The Act did not prescribe the manner in which the reduction of capital was to be effected. Section 9 listed two requirements for a reduction, viz, a special resolution of shareholders and confirmation by the Court. A leading text commented on the new law as follows:[6]

"This, the most important portion of the new Act, is intended to meet that popular demand for a reduction of the nominal capital of a company, which led to the nomination of the committee of the House of Commons, on whose recommendations this Act was eventually founded."

The position, therefore, is that before 1867 it would be accurate to think of a company's capital as constituting an inviolable fund which although may be lost through trading must otherwise be kept for the benefit of the company's creditors. This will be referred to as the inviolable fund concept in this paper. The concept, when translated into practical operation, means that the company's capital figures cannot be reduced. However, as stated above, since 1867 statute had allowed a company to reduce its capital if it was supported by a special reduction and approved by the court. In substance this procedure has continued until today, though the legislative provisions and their operation have become more flexible.[7] The shape of capital maintenance hence depends on the creditor protection mechanism set out in the relevant statutory provisions and the manner in which the courts exercise their discretion to confirm a capital reduction. For example, if a company is allowed to return its capital to its shareholders and they do not come under a liability to return those sums of money to the company, it is impossible to continue to adhere to the "inviolable fund" concept. Before explaining the different ways of reducing capital and the different methods of creditor protection, it is necessary to deal briefly with two issues.

(b) Fair treatment of shareholders

This paper is concerned with explaining and evaluating the functions of the doctrine in protecting creditors. However, once a company is allowed to reduce its capital, this facility may be used to benefit one or more shareholders at the expense of others. For example, a company may use a capital reduction to return capital to one or some of the shareholders at the expense of the rest of the shareholders. Therefore,

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⑤ Companies Act 1867, s 9.

⑥ Gore Brown, *A Treatise on the Companies Act* 1862 (Stevens & Haynes, 1867, London).

⑦ UK Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* [5.4.4] – [5.4.5].

quite apart from protecting creditors, the doctrine is also concerned to ensure that shareholders are treated fairly. A court will exercise its discretion in favour of a proposed reduction of capital only if satisfied (a) that the shareholders are treated equitably, ie, that the proposed reduction affects all shareholders in a similar manner, or that those treated in a different manner from their equals have consented to that treatment, (b) that the cause of the reduction was properly put to shareholders so that they could exercise an informed choice, and that the cause is proved in evidence before the court, and (c) that the reduction is for a discernible purpose. [8]

(c) Uncalled capital

It was very common previously for subscribers of shares not to pay for the full price of the shares. The practice has since become much less common. The unpaid portion of the share price is a debt which the shareholder owes to the company, and the unpaid share price owed by all the shareholders of the company constitutes its uncalled capital. The uncalled capital may be called up by the company while it is a going concern or when it is wound up or is in judicial management. When a company is wound up, its members are contributories. [9]If the assets of the company are insufficient to pay its debts and liabilities, the court has the power to make calls on the contributories to pay the uncalled capital that they owe to the companies, [10] although in practice this power is usually delegated to the liquidator. [11]If the company is in judicial management, the judicial manager has the power to call up any uncalled capital of the company. [12]

Under section 65(2), it is valid for a company by special resolution to determine that its uncalled capital shall not be capable of being called up except in the event and for the purposes of the company being wound up. This enables a company to retain its uncalled capital as a reserve to be called up in the event it is wound up. As this provision is not made subject to judicial management, it would seem that if such a special resolution has been passed, a judicial manager would be unable to exercise the statutory power conferred on him to call up the uncalled capital.

(d) Different ways of reducing capital

The methods of creditor protection depend on the type of capital reduction. There are many different ways to reduce capital, and they contradict the inviolable fund concept in different ways. Stripped of their technicalities it is possible to place a capital reduction into one or more of the following categories: (a) the reduction or extinction of a member's liability to pay the amount unpaid on his shares, (b) the cancellation of any paid-up capital which is lost or unrepresented by available assets or (c) the return of money or assets to the company's members. [13]A capital reduction that involves only the cancellation of

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[8] See for eg, *Re Jupiter House Investments (Cambridge) Ltd* [1985] 1 WLR 975, 978; *Re Ratners Group plc* (1988) 4 BCC 293, 295; and *Re Thorn EMI plc* (1988) 4 BCC 698, 701.

[9] s 250.

[10] s 281 (compulsory winding up); s 310 (voluntary winding up).

[11] s 288 (compulsory winding up); s 305 (voluntary winding up).

[12] 11th schedule, para (s).

[13] s 78A(1). See also *Halsbury's Laws of Singapore* Vol. 6, [70.480].

any paid-up share capital which is lost or unrepresented by available assets, usually called a *loss reduction*, contradicts the inviolable fund concept in that the company's capital yardstick is reduced,[14] but it does not otherwise prejudice the company's creditors, unless it has hidden value in its balance sheet in the form of undervalued assets or over provision in respect of liabilities.[15] A return of capital to the company's members, usually called a *repayment reduction*, on the other hand, reduces the company's assets and its capital and is potentially prejudicial to creditors of the company. Both forms of capital reduction have been approved, as may be seen from the following two cases.

In *Re Grosvenor Press Plc*,[16] a company proposed to cancel capital that was lost. As the company could not prove that the loss of capital was permanent, it gave an undertaking to the court that a special reserve would be set up if any of the lost capital was recovered which would not be available for distribution until creditors existing at the date when the reduction became effective have been paid off. Nourse J approved the reduction, stating that the "statutory procedures which allow for its reduction demonstrate that there is no status of inviolability attaching to a company's capital."[17] In *Ex p Westburn Sugar Refineries Ltd.*,[18] the company, in anticipation of the nationalisation of its assets, proposed to return to its members part of its paid-up share capital in the form of shares in another company. As the company's financial position was extremely strong, with its current assets far exceeding its current liabilities, the court approved the reduction, noting that the creditors were amply provided for.

Therefore, the concern of the courts in approving capital reduction, in so far as creditors' interests are concerned, is how those interests may be protected in an appropriate way. The starting point is that the statutory mechanism requires the court to settle a list of qualifying creditors unless it is a loss reduction. However, various methods have been developed to circumvent this requirement. Both will be explained below.

(e) Settling a list of creditors

The court is required prima facie to settle a list of creditors in two situations, namely, when a capital reduction is a repayment reduction or when it involves a reduction of liability in respect of unpaid share capital, unless the "special circumstances of the case" make it proper for the court to direct otherwise.[19] The court may also on its own motion require a list of creditors to be settled in other types of capital reduction.[20]

If a list of creditors is settled, the court cannot confirm a proposed reduction unless the creditors on

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[14] This is important in jurisdictions where a company may not pay dividends unless its capital is intact, such as UK (Companies Act 2006, s 830) and HK (Companies Ordinance, s 79B) but is irrelevant to Singapore as dividends may be paid out of trading profits even though the company's capital is not intact; *Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1 (CA) 26.

[15] For the modern approach to loss reductions, see *Re Jupiter House Investments (Cambridge) Ltd* [1985] 1 WLR 975; *Re Grosvenor Press Plc* [1985] 1 WLR 980.

[16] [1985] 1 WLR 980.

[17] Ibid 985.

[18] [1951] AC 625 (HL).

[19] s 78H(1), (2), (3); Companies Act 2006, s 645(2), (3).

[20] s 78H(1); Companies Act 2006, s 645(4). In *Re Meux's Brewery Ltd.* [1919] 1 Ch 28, in a capital reduction that did not involve a diminution of liability or a repayment of capital, the creditors failed to persuade the court that they should be allowed to object to the proposed reduction.

the list consent to it or their debts or claims are dealt with in accordance with the statutory requirements. In England, the company is required to pay or secure the debts or claims.[21] The law was changed in Singapore, pursuant to the Companies (Amendment) Act 2005, so that in addition to providing security, the court has power to confirm a reduction where the creditors have other "adequate safeguards" for the debts or where the court thinks that security or other safeguards are unnecessary "in view of the assets the company would have after the reduction".[22] In practice, however, it is extremely rare for the court to direct the settlement of a list of qualifying creditors:

"Given the cumbersome nature of the procedure... companies invariably seek to avoid the requirements... by ensuring that the reduction is structured in a manner not involving any adverse consequences for creditors. Indeed, it is understood that the last occasion on which the settlement of a list of creditors was ordered was 1949."[23]

The most convenient form of creditor protection to be adopted will generally be determined by two main factors, namely the form of the reduction and the nature of the creditors of a company. In practice, protection in one or more of the following forms have been used: consent from creditors, payment, appropriating money in a blocked account to meet creditors' claims, provision of security orbank's guarantee, giving the court an appropriate undertaking or retaining sufficient assets to meet the claims of creditors.[24]

(f) Creditor protection in repayment reductions

In repayment reductions, the court will dispense with the need to settle a list of creditors if one of the following methods of protecting creditors is adopted.

First, a company can show that it has sufficient liquid assets to cover the aggregate of any amount of capital proposed to be repaid to members and the total sum due to creditors plus a margin of not less than 10%. Narrow-range investments as defined in the Trustee Investments Act 1961 will be accepted at their full market value and wider-range investments at one-half of their market value. Evidence must be produced both of the level of creditors and the value of the relevant liquid assets. The latter is normally done by way of a bank certificate or up-to-date bank account statements.

Secondly, a company can set aside in a blocked bank account a sum of cash equal to the value of its non-consenting creditors and to undertake to the court to restrict the use of that account to discharging the claims of those creditors. In effect, the company is creating a trust account which would not be regarded, on a subsequent winding up, as representing an asset of the company available for distribution to the general body of creditors.

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[21] In the case of securing the claims, the company must appropriate, in the case of admitted debts (or debts which are not admitted but which the company is willing to provide for) the full amount of the debt or claim, and in the case of other debts (including contingent debts) such amount as the court shall direct. See Companies Act 2006, s 646(4), (5).

[22] s 78I(2).

[23] Millett and Alcock (eds), *Gore-Browne on Companies* (Jordans, 45th Ed, 2005) [64(18)].

[24] This reflects the practice in Britain, as discussed in Millett and Alcock (eds), *Gore-Browne on Companies* (Jordans, 45th Ed, 2005) [64[18]] et seq. There seems to be no text that discusses the practice in Singapore, but as Singapore's legislation on capital reduction is very similar to that in Britain, it is surmised that the practice in Singapore would also be similar to the practice in Britain.

Thirdly, a company can choose to put into place a bank guarantee for the protection of its non-consenting creditors. The amount of the guarantee must be the lesser of the amount of the reduction and the aggregate amount of the value of the debt owed to the non-consenting creditors.

Fourthly, a company may also offer an undertaking to the court. The undertaking could take one of a number of forms. For eg, the company could undertake not to make any repayment of capital until such time as all creditors have either been paid off or consented to the reduction. In this circumstance, the amount of capital cancelled would be held, pending that time, in a special reserve in the balance sheet of the company. [25]

(g) Creditor protection in loss reductions

Where it can be proved that the loss is permanent, the reduction does not prejudice creditors. Where however it cannot be so proved, the current practice is that laid down in *Re Grosvenor Press Plc*. [26] The court will accept an undertaking from the company that if any of the missing capital is recovered, it would be set aside in a special reserve so that the interests of the company's creditors existing at the date when the reduction is to take effect would not be prejudiced. It is not necessary that the reserve should remain permanent.

(h) Restatement of doctrine

The above discussion proves that it is a gloss to think that capital requirements in England and Singapore are based on the inviolable fund concept. [27] It should also be said that the dividend rules are at odds with that concept. England has reformed its rules on dividends so that a company is not allowed to declare dividends unless its capital is intact. [28] The position in Singapore, on the other hand, is still based on the common law developed by English judges in the last century. The base line is contained in the statutory provision that dividends may only be declared out of available profits, [29] but there is no definition of what constitutes profits. If we adhere to the inviolable fund concept, it must mean there are only profits if a company's capital is intact. However, whilst that was the position before 1889, the English courts resiled from that position in a series of cases, [30] as may be seen from the following passages.

"A single unifying idea runs through the decisions in dividend cases before the year 1889. This idea was premised on the view that the provisions of the Acts regarding the capital of a company, and more especially its reduction, made it clear that the Legislature would have frowned upon any dividend payment which would have left the company with a sum of assets less, in value, than its nominal paid-up capital.

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[25] This form of undertaking is also used in loss reduction where it could not be proved that the loss is permanent. See *Re Grosvenor Press Plc* [1985] 1 WLR 980.

[26] [1985] 1 WLR 980.

[27] With respect, it is submitted that the manner of exposition in most texts may be improved; eg, John Farrar and Brenda Hannigan (eds) *Farrar's Company Law* (Butterworths, 4th Ed, 1998) ch 16, Eilis Ferran *Company Law and Corporate Finance* (OUP, 1999) ch 10; Tan Cheng Han (ed), *Walter Woon on Company Law* (Sweet & Maxwell Asia, 3rd Ed, 2005) [12.6] et seq. *Cf.* Paul Davies (ed), *Gower and Davies' Principles of Modern Company Law* (Sweet & Maxwell, 7th Ed, 2003) ch 11.

[28] Companies Act 2006, s 830.

[29] See for eg, s 403(1).

[30] The first, and most important case, is *Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1.

It was argued that the paid-up capital of a company could be used only for the furtherance of the declared objects of the company, which did not include the return to the shareholders of the capital they had subscribed. Moreover, the statutory ban on the reduction of capital, except under the strict supervision of the Courts, was held to imply that it was not legal to reduce the capital by returning it to the shareholders, without safeguards, in the guise of dividends. "[31]

"In the first place, the doctrine of the earlier period before 1889 which, in substance, stated that no dividend payment could be made unless the remaining assets (valued according to accepted conventions) were at least equal to the nominal capital, is no longer operative. It has been replaced by rules and principles giving to company directors the maximum of freedom in the declaration and payment of dividends. The emphasis has swung from creditor-protection to non-interference. "[32]

Therefore, it is more accurate to state the capital maintenance doctrine in the following propositions.

First, the capital maintenance doctrine relies on the capital subscribed by members of the company to erect a body of rules to protect creditors.

Secondly, *prima facie* the company is required to retain assets equivalent to its subscribed capital for the benefit of its creditors.

Thirdly, the*prima facie* position is subject to the important qualification that companies' legislation does allow a company to reduce its capital in any way, including returning capital to its members, provided that the interests of creditors are adequately protected,[33] and in Singapore, a company may declare dividends even when its capital is not intact. In capital reduction cases, English courts have, in exercising their discretion over the last one hundred plus years, accepted different methods as providing adequate protection. Unfortunately, they have not laid down any general principle in relation to the exercise of the discretion beyond saying that creditors should be safeguarded. This is probably because the fact situations are so diverse that it is difficult to generalise and also because judges have regarded this as a matter of practice.[34]At this stage, the most that can be said is that in a loss reduction, the court is mostly concerned that subscribed capital should not be returned surreptitiously to the members.[35]In a repayment reduction where creditors have not given their consents, the court is mostly concerned that their interests are safeguarded through the setting aside of assets as security or the retention of sufficient assets in the company to meet the claims of the creditors.[36]

Fourthly, the prima facie position is subject to the further qualification that under Singapore law a company may declare and pay dividends even where its capital is not intact, ie, "nimble dividends" as the Americans described payments in such circumstances. Compared to the aforesaid capital reduction, this is an even larger inroad into the inviolable fund concept. It has thus been said that "[H]adcompanies taken

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[31] Basil Yamey, "Aspects of the Law Relating to Company Dividends" (1941) 4 MLR 273, 274.

[32] Basil Yamey, "Aspects of the Law Relating to Company Dividends" (1941) 4 MLR 273, 285 – 286.

[33] It may also be added that since 1998 share buybacks were allowed: Companies (Amendment) Act 1998, s 5 which introduced s 76B to s 76G.

[34] See for eg *Re Jupiter House Investments (Cambridge) Ltd* [1985] 1 WLR 975, 978 (the observations of Lord Macnaghten in *Poole v National Bank of China Ltd* [1907] AC 229, 238 – 240, do not represent the law as practiced in this court); *Re Grosvenor Press Plc* [1985] 1 WLR 980, 983 ("settled general practice as to the form of undertaking to be required").

[35] See for eg, *Re Jupiter House Investments (Cambridge) Ltd* [1985] 1 WLR 975; *Re Grosvenor Press Plc* [1985] 1 WLR 980.

[36] See for eg, *Ex p Westburn Sugar Refineries Ltd* [1951] AC 625 (HL).

full advantage of these rules... it would have made nonsense of the whole capital concept". [37]

(i) Criticisms of doctrine

It has been explained at the beginning of this paper that the civilian methods of imposing minimum capital requirements suffer from various drawbacks, and that English law makes use of capital in a different way to protect creditors. Unfortunately, the English approach is also seriously flawed. First, it does not provide consistent or reliable protection for creditors, which is the main reason for its existence. The reason is because it is based on capital figures in a company's balance sheet which are historical. [38] As explained by David Wishart: [39]

"Almost as soon as a company is incorporated, the fund of capital represented by the share capital of the company does not indicate how much money there is in the company to repay the debt. In many respects future earnings are much more important. Further, if the company has had time to trade, profits and losses will have added to or detracted from the funds available to creditors. To refer back to a historical figure for a measure of the money available in a company was patently useless. Creditors relied on their own assessment of creditworthiness and charged for risk. Once creditors determined exactly how much money in their opinion would be available they became concerned about dissipation of that fund. In this respect the rules derived from the principle of maintenance of capital performed the useful function of preventing other interests, mainly the shareholders, from taking undue priority. However, they were misdirected in protecting the capital fund as an absolute figure."

Secondly, although the provisions for the protection of creditors and their operation have become more flexible over the last one hundred plus years, nonetheless a company wishing to reduce capital may find that the court requires it to provide an expensive bank guarantee to cover present and future claims of its existing creditors, however financially sound the company may be. This makes creditors better protected than they would otherwise have been, at the expense of the company. Such an approach is not efficient. [40]

Thirdly, creditors today rely on other measures to protect themselves. The UK Company Law Review concluded that "a company's share capital is nowadays relatively unimportant as a measure of its ability to repay credit, and that other measures, including net assets, cash flow and interest cover are considerably more important." [41] As such, the capital maintenance rules may end up imposing costs and restrictions on company management without countervailing benefits.

Fourthly, the evolution of the dividend rules shows that the strictures of the capital maintenance doctrine were felt as early as 1889. In *Lee v Neuchatel Asphalte Co*, [42] Lindley LJ departed from earlier

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[37] LCB Gower, *Gower's Principles of Modern Company Law* (5th edn, Sweet & Maxwell, 1992) 244.

[38] John Armour, "Legal Capital: An Outdated Concept" (2006) 7 European Business Organization Law Review 5; Jonathan Rickford, "Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests" (2006) 7 European Business Organization Law Review 135.

[39] David Wishart, "Company Law in Context" (OUP, 1994) p 177.

[40] CLR Steering Group *The Strategic Framework* (Feb 1999) [5.4.5].

[41] CLR *Company Formation and Capital Maintenance* Oct 1999, [3.5].

[42] (1889) 41 Ch D 1.