EXPLANATORY MEMORANDUM TO

THE COMPANIES (REDUCTION OF SHARE CAPITAL) ORDER 2008

2008 No. [DRAFT]

1. This explanatory memorandum has been prepared by the Department for Business, Enterprise and Regulatory Reform and is laid before Parliament by Command of Her Majesty.

2. Description

The draft Companies (Reduction of Share Capital) Order 2008 does two things. First, it prescribes the form in which a solvency statement must be made when a private company proposes to reduce its share capital in reliance on such a statement without getting a court order. Secondly, it provides that when a company reduces its share capital (by any means, including under provisions of the Companies Act 1985 still in force), a reserve arising from that reduction is to be treated as a realised profit for the purposes of rules about distributions of companies' assets in Part 23 of the Companies Act 2006 unless (in the case of a court-approved capital reduction) the court orders otherwise, and subject to other exceptions. This means that the reserve is, in principle, distributable subject to the requirements of Part 23 of the 2006 Act being satisfied.

3. Matters of special interest to the Joint Committee on Statutory Instruments

None.

4. Legislative Background

The instrument relates to sections 643 and 654 of the Companies Act 2006 ("the 2006 Act").

5. Territorial Extent and Application

The instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

Gareth Thomas has made the following statement regarding human rights:

In my view the provisions of the draft Companies (Reduction of Share Capital) Order 2008 are compatible with the Convention rights.

7. Policy Background

7.1 The draft Companies (Reduction of Share Capital) Order 2008 is intended to meet two objectives. It prescribes the form in which a solvency statement must be made; and provides in respect of the treatment of reserves arising from a reduction

in share capital (whether supported by solvency statement or approved by court order or, in the case of an unlimited company, in a manner permitted by its articles) that, when a company reduces its share capital, subject to some exceptions, a reserve arising from the reduction is (unless, in the case of a court-approved reduction, the court orders otherwise) treated as a realised profit for the purposes of the rules in the Companies Act 2006 about the distribution of a company's assets.

Solvency Statement

7.2 If a private company wants to take advantage of the solvency statement route to reduce share capital, the company's directors have to form the opinion:

- that at the date of the statement there are no grounds on which the company could then be found to be unable to pay its debts;

- that, if the intention is to start winding up the company within the next twelve months, the company will be able to pay its debts in full within twelve months of the commencement of the winding up; and

- that, if there is no such intention, the company will be able to pay its debts as they fall due during the twelve months following the date of the statement.

If company directors make a solvency statement without having reasonable grounds for the opinions expressed in it, and the statement is delivered to Companies House, an offence is committed by every director who is in default. The offence is punishable by a fine or by a maximum period of imprisonment of two years or both.

Treatment of reserves arising from a reduction in share capital (distributions)

7.3 The effect of the draft Order is that reserves resulting from a reduction of capital are, subject to any contrary court order, to be treated as realised profits for Part 23 of the Companies Act 2006 (which sets out the rules for the distribution of a company's assets), and their distribution is thereafter controlled by Part 23.

7.4 Theprovisions of the draft Order on the distribution of reserves do not affect the operation of anything to the contrary in a court order, in an undertaking to the court, in a relevant resolution passed by the company's members, or in the company's memorandum or articles.

7.5 A consultation exercise was conducted between February and May 2007 on secondary legislation to be made as part of the Government's implementation of the Companies Act 2006. Draft provisions relating to reduction of share capital, including the provisions now contained in the draft Order laid before Parliament, were published on the Department's website in May 2007 for comment. The draft Order has been amended in the light of responses to this consultation and discussions with key stakeholders, but the substance of the draft Order is essentially the same.

7.6 A revised draft of the Order was placed on BERR's website for comment in May 2008. The draft Order incorporates technical amendments made in the light of that consultation.

8. Impact

a. An Impact Assessment is attached to this memorandum. The draft Order is permissive in nature and there are no obvious significant costs or burdens on companies.

b. We are unaware of any significant costs arising to Companies House from the introduction of this procedure.

9. Contact

Phillip Nicholls at the Department for Business, Enterprise and Regulatory Reform, telephone: 0207 215 3091 or e-mail: Phil.Nicholls@berr.gsi.gov.uk, can answer any queries regarding the instrument.

SUMMARY: INTERVENTION & OPTIONS

Department for Business, Enterprise and Regulatory Reform	Impact Assessment of The Companies (Reduction of Share Capital) Order 2008

Stage	Version	Related Publications: Implementation of Companies Act 2006 Consultative Document February 2007 http://www.dti.gov.uk/consultations/page37980.html
Final 23/4	one	

Available to view or download at: www.

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What is the problem under consideration? Why is government intervention necessary?

There are two issues.

1. The need to prescribe the form in which a solvency statement must be made when a private company proposes to reduce its share capital when relying on the statement without getting a court order; and
2. The need to provide that when a company reduces its share capital, and the reduction has been confirmed by a court order, subject to three exceptions, the reduction is distributable unless the court orders that it is not.

Government intervention

Under Company Law there is no minimum capital requirement for private companies but there are restrictions on how capital invested in a company is subsequently treated. The restrictions reduce the likelihood of shareholders – who are protected through the mechanism of limited liability - behaving in an opportunistic manner, which might, ultimately, be at the expense of creditors or possibly minority shareholders. The use of the court route method, and now the option of a solvency statement, for any capital reductions enables creditors to take comfort from capital invested in the company whilst also providing flexibility for the directors of the company to manage the business efficiently and return unused capital appropriately.

What are the policy objectives of the Regulations and their intended effects?

The objectives are

(i) to prescribe the form in which a solvency statement must be made; the content is dictated by Companies Act 2006 section 643. The Registrar of Companies will also have powers to impose, via Companies House rules, requirements relating to the form, manner of delivery and authentication of the copy of the solvency statement, which will need to be registered at Companies House.

(ii) to provide for the treatment of reserves arising from reduction in share capital including where a solvency statement has been used to reduce share capital; and to end reliance on professional guidance in these matters

The intended effects are

- to provide a simplified and non-court mechanism by which a private company can reduce its share capital, which is cheaper and has a lighter legislative touch.
- to clarify the treatment of reserves arising from a reduction of share capital in all circumstances (including where the new solvency statement has been used) and to make the treatment of reserves a matter of legislation rather than one of professional guidance.

The introduction of the solvency statement route and the clarification of treatment of reserves arising from share capital reductions is viewed as effect neutral for creditors.

What policy options have been considered? Please justify any preferred option.

Capital Reduction by private companies using solvency statement – under the Companies Act 1985 capital reduction for both private and public companies requires court confirmation. The Company Law Review recommended a non-court route for capital reduction by private companies. Consequently the policy option that existed was to introduce a non-court procedure for private companies to reduce share capital or not to introduce it: business welcomes its introduction.

Distributions – the treatment of reserves arising from reductions in share capital is currently subject to the provisions of the Companies Act 1985 and lengthy, and complex, professional guidance issued by the Institute of Chartered Accountants in England and Wales (ICAEW). Under the Companies Act 2006 the policy options were to replicate what existed under the Companies Act 1985 thereby continuing reliance on the professional guidance or setting out in legislation, by means of secondary legislation provided for by the 2006 Act, how such reserves were to be treated. Key stakeholders, the ICAEW, supported by the Law Society, favoured setting the treatment of reserves in legislation and that was the policy option adopted.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

3 – 5 years

Ministerial Sign-off:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options

Signed by the responsible Minister:

Gareth Thomas

Date: 4th June 2008

SUMMARY: ANALYSIS & EVIDENCE

Policy Option :

ANNUAL COSTS One off (Transition) nil Yrs **Average Annual Cost** (excluding one-off)	See "Costs and Benefits" in Evidence Base below
Other **key non-monetised costs**	
ANNUAL BENEFITS One off Yrs **Average Annual Benefit** (excluding one-off)	See "Costs and Benefits" in Evidence Base below **Total Benefit** PV
Other **key non-monetised BENEFITS**	
KEY Assumption/Sensitivities Risks	

Price Base Year	Time Period Years	Net Benefit Range (NPV) £-£	**NET BENEFIT** (NPV Best Estimate) £

What is the geographic coverage of the policy/option?	UK				
On what date will the policy be implemented?	1 October 2008				
Which organisation(s) will enforce the policy?	Companies House				
What is the total annual cost of enforcement for these organisations?	nil				
Will implementation go beyond minimum EU requirements	no				
What is the value of the proposed offsetting measure per year?	n/a				
What is the value of changes in green gas emissions?	n/a				
Will the proposal have a significant impact on competition?	no				
Annual cost per organisation (excluding one-off)	Micro 0	Small 0	Med 0	Large 0	
Are any of these organisations exempt?	No	No	No	No	

Impact on Admin Burdens Baseline (2005 prices)

Increase of Decrease of **Net Impact**

Evidence Base
for Summary Sheets

Background

1. A consultation exercise was conducted between February and May 2007 on secondary legislation to be made under the Companies Act 2006. Draft regulations were published on the department's website in May 2007 for comment, including provisions relating to the new solvency statement route for capital reduction. Although the draft Companies (Reduction of Share Capital) Order 2008 is not identical to the draft regulations published in May 2007, the substance of the Order is essentially the same as the substance of the equivalent provisions in those draft Regulations and is a consequence of that consultation exercise and subsequent contributions from stakeholders.

2. Under the Companies Act 1985 the treatment of reserves arising from a reduction of share capital has been governed by professional guidance issued by the Institute of Chartered Accountants in England and Wales (ICAEW). The guidance is long and complex, and representations were made by the ICAEW and the Law Society (LS), that the opportunity should be taken to clarify the treatment of such reserves in legislation. We have consulted at length with both the ICAEW and LS to achieve an agreed draft Companies (Reduction of Share Capital) Order and we now wish to secure wider acceptance by placing the same on the departmental website, for information and views, for a period of four weeks.

3. On 1 October 2008 provisions of the Companies Act 2006 will be commenced enabling private limited companies to reduce their share capital by means of a new procedure, the solvency statement route, which will not require court involvement. Currently both public and private limited companies must have a reduction of share capital confirmed by court order.

4. Traditionally companies limited by shares have been seen as a mechanism by which the owners – shareholders – limit how much of their money is at stake and this money can only be returned to shareholders in certain circumstances. For many private companies the existing framework for return of capital is unnecessarily complicated and its simplification offers a beneficial deregulatory outcome.

5. The changes are permissive and in the majority of cases there are no obvious costs; we anticipate that any costs to a company that arise will be marginal and that they will be more than offset by the cost savings that flow from the de-regulatory measure in question.

6. It is clear that the measures in the 2006 Act will save companies both time and money as they will be able to avoid the necessity of going to court to restructure its share capital i.e. in the case of capital reductions by private companies. Under the Companies Act 1985 the procedure for reducing share capital for both private and public companies involves confirmation by a court, which can be both time-

consuming and expensive. The change in legislation – to introduce for private companies a non-court route for reducing capital – requires government action.

7. Where there has been a reduction of share capital the Order provides clarity as to the treatment of any reserves arising from that reduction. Furthermore there is a strong element of creditor protection in that where a limited company reduces its share capital it must put that reduction through its profit and loss account (so diminishing or cancelling losses on that account) before the funds become available for distribution to shareholders.

Costs and benefits

8. There is no data on the sums companies expend in complying with the relevant Companies Act 1985 legislation and consequently we are unable to calculate the financial costs or benefits that will arise from the proposed changes. We have however taken informal soundings from stakeholders and we are content that in relation to the introduction of the solvency statement procedure

   - only minimal costs to private companies may arise from having to complete forms and registering them at Companies House;

9. Benefit will accrue from matters including:

   - not having to 'settle' a list of creditors as is required in the court procedure,
   - not having to put into place arrangements to satisfy the court that debts are provided for, and
   - not having to fund professional advisors to ensure these matters are undertaken appropriately via the courts

10. We are unaware of any significant costs arising to Companies House from the introduction of this procedure.

11. The Courts will benefit from not having to confirm reductions of share capital for private companies in every case.

12. Matters relating to the clarification of treatment of any reserves arising from a reduction of share capital, i.e. distribution, do not have obvious mandatory costs.

Available sanctions

13. The available sanctions need to be understood in context; as the balance to providing a reduced burden on companies and greater flexibility for company directors.

14. If the directors make a solvency statement without having reasonable grounds for the opinions expressed in it, and the statement is delivered to the registrar of companies every director who is in default will be guilty of an offence punishable by a fine or up to two years imprisonment. We do not believe that directors will be "put off" from using the solvency statement route because the sanction is available. Informal feedback suggests that the solvency statement route is being widely anticipated and we understand companies are currently deferring court route applications preferring instead to wait until post-October 2008 so that they can take advantage of the solvency statement route.

15. There is no requirement for directors to obtain professional advice when making a solvency statement. Directors are the stewards of their companies and therefore aware of the trading and financial status; if they seek professional advice that is a matter for them. There is no basis to support a view that benefits accrued will be reduced by directors seeking professional advice.

Mandatory Impact Tests

16. We have considered the three mandatory impact tests (gender, race, disability) and the recommended options are unlikely to have any discriminatory effects.

Specific Impact Tests - Checklist

Type of testing undertaken	***Results in Evidence Base? (Y/N)***	***Results annexed? (Y/N)***
Competition Assessment	*n/a*	
Small Firms Impact Test	*n/a*	
Legal Aid	*n/a*	
Sustainable Development	*n/a*	
Carbon Assessment	*n/a*	
Other Environment	*n/a*	
Health	*n/a*	
Race Equality	*y*	
Disability Equality	*y*	
Gender Equality	*y*	
Human Rights	*n*	
Rural Proofing	*n/a*	