Involuntary Creditors and the Case for Accounting-Based Distribution Regulation

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driver'. The second objection and driver of reform is that the reliance of distribution regulation on accounting based tests means that changes in accounting standards may unintentionally distort capital markets by preventing financially healthy and solvent companies from issuing dividends. Affected companies may experience an increase in their cost of equity capital as their investor base shrinks because these companies are no longer attractive investment options for those investors who require regular dividends. This cost of capital increase is, it is argued, unnecessary. These distortions can be removed whilst at the same time protecting creditors' interests through an approach that would allow distributions where company directors certify the solvency of the company at the time of the distribution and for a period thereafter. This article refers to this driver of reform as the 'distortion driver'.

This article considers these two drivers of reform from the perspective of the involuntary, non-adjusting creditor. According to the *constituency driver* involuntary creditors are not protected by the distribution rules and therefore have nothing to lose through their reform. According to the *distortion driver* creditors, including involuntary creditors, are as well protected by the solvency certification approach. It follows, therefore, that involuntary creditors would be indifferent to reform that replaces the current regime with a solvency-based approach. In relation to the *constituency driver*, this article argues that involuntary creditors obtain distinct and tailored benefits from current distribution regulation. These benefits, the article argues, have been underweighted and unexplored as a result of a tendency in the literature to amalgamate regulatory function with effect. Although the rules were conceived as part of the capital maintenance doctrine and although the functional 'best fit' may well be to prevent opportunistic returns of capital to shareholders, in application the rules have had broader effects and have generated unintended constituencies. Following the identification of these benefits, the article considers the *distortion driver* and considers whether a solvency certification provides equivalent protection for involuntary creditors. It argues that on balance the solvency certification approach would diminish the identified protection provided to involuntary creditors under the current rules.

THE CONSTITUENCY DRIVER

THE LOGIC OF CAPITAL MAINTENANCE

English law has long had rules regulating when companies can make distributions of assets to their shareholders. Basil Yamey, writing in 1941, distinguished between pre-1889 and post-1889 case law.[1] The former exemplified by *Re*

Flitcrofts's Case[2] required that a distribution could not be made out of capital which, strictly speaking, meant that the distribution could not result in an accounting reduction of the capital account[3] to an amount below the legal capital entry. Legal capital[4] at this time consisted of the aggregate nominal value of the issued

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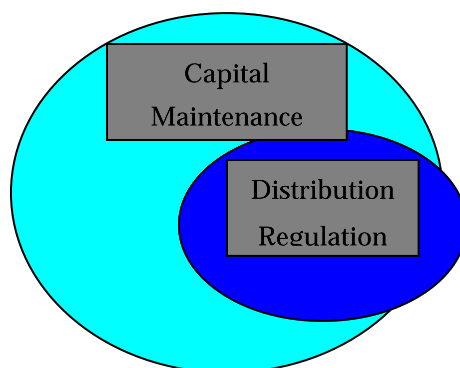
post-contractual opportunism by the company to transfer value from creditors to shareholders.[18] According to this understanding, at the time of contracting creditors incorporate into their assessment of the risk and required return of their

shareholders is zero'.[22] If the level of capitalization is, in fact, set above zero in a particular company then the rules will provide some protection for involuntary creditors. However, as such protection is fortuitous such creditors are not deemed a regulatory constituency. An interdisciplinary group of lawyers and accountants (the 'Interdisciplinary Group'), who recently argued strongly in favour of reforming the distribution rules, also view reliance by adjusting creditors as an important way of making sense of the distribution rules:

> *Thus* creditors may *rely* on this amount of assets being present to satisfy their claims, unless it has been reduced by trading. Even if it has been reduced in this way, they may *rely* on the amount of the original capital fund being replenished before assets may be returned to shareholder (emphasis added).[23]

assuming that the distribution rules were designed to protect creditors by maintaining capital vis-à-vis shareholders, in practice the rules' over-inclusive application has generated effects and protected constituencies beyond the boundaries of the original purposive intent. This is not, of course, to dispute the fact that the existing rules, in conjunction with applicable accounting standards, do maintain (vis a vis shareholders) the legal capital accounts of UK companies and that the potential insignificance of the capital contribution for UK companies means that adjusting creditors are the only creditors who can adjust to *this firm specific variable*. The argument here is that protection of legal capital vis a vis shareholders is but one aspect of what the distribution rules do in practice and only one of the ways in which the rules can benefit creditors. If there is a capital maintenance doctrine then distribution regulation would relate to it diagrammatically as follows:

Figure 1



The UK's current distribution rules allow distributions to shareholders to the extent that both net-assets exceed share capital and undistributable reserves[27] and accumulated realised profits exceed accumulated realised losses.[28] Both tests do indeed function to ensure that legal capital is not distributable to shareholders. That is not, however, all that they do. By looking at these rules without the lens of the capital return function, we can ask simple but probing questions about the effects of the rules. The net-assets distribution test, for example, involves several components. Broadly understood it prevents distributions until asset value has been generated in excess of all existing liabilities in addition to legal capital. From

of how non-adjusting creditors may benefit from distribution rules that rely on accounting-based tests.

PROTECTION FOR INVOLUNTARY CREDITORS THROUGH DISTRIBUTION REGULATION

There are two ways in which the regulation of the use and disposition of a company's assets could protect the interests of non-adjusting involuntary creditors. The first type of protection relates to those individuals who have become involuntary creditors. Here regulation can *increase* the likelihood that involuntary creditors will be remunerated in full and incentivise the company to compensate the claimant quickly. The second type of protection would involve disincentivising investment decisions that produce involuntary creditors or incentivising the taking of appropriate safety precautions to prevent injury to third parties. The *constituency* of involuntary creditors is protected by reducing the probability that one of us will become an involuntary creditor. Existing UK distribution regulation provides protections for involuntary creditors in both of these respects.

Protecting Existing Creditors

If any amounts *actually or potentially* owed by the company to involuntary creditors either decreases net-assets or increases accumulated realised losses, the extent to which the company may make a distribution will be reduced by the amount of the relevant involuntary creditor liability or loss entry. Whether this affects the ability of the company to make the distribution it wishes to make will depend on the size of the liability or loss entry and the value of existing assets and accumulated realized profits.

Pursuant to UK generally accepted accounting principles (UK GAAP), a company's financial statements, in both the balance sheet and through the profit and loss account, must take account of potential as well as actual liabilities. Currently the probability that a liability will have to be paid in the future determines how it is accounted for in the financial statements. Under current UK *Financial Reporting Standards*, as well as the applicable *International Accounting Standards* and *International Financial Reporting Standards*,[29] the treatment of a potential liability depends on whether it is dealt with as a

information about such potential liability. The distribution rules note generally that provisions are to be taken account of in determining the amount of any distribution[30] and specifically that provisions are treated as liabilities for the purpose of the net-assets test[31] and realised losses for the accumulated profits test.[32]

The UK accounting standard on provisions and contingent liabilities is set forth in Financial Reporting Standard 12*, Provisions, Contingent Liabilities and Contingent Assets*. FRS 12 mirrors International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets* which is applicable to the consolidated accounts of UK listed companies. According to FRS 12, a provision, which is defined as 'a liability that is of uncertain timing and amount',[33] must be recognised[34] when: a company has a 'present obligation' arising from a 'past event'; it is more likely than not that 'economic benefits' must be transferred by the company to settle the obligation;[35] and where a 'reliable estimate' of the amount of the obligation can be made.

A present obligation includes both legal and constructive obligations. Legal obligations include those arising from contract, legislation or operation of law.[36] Constructive obligations may arise, amongst others, from a pattern of past practice or the creation of an expectation in third parties.[37] An involuntary creditor such as a person injured by company products or activities, with a product liability or tort claim, would be owed a *legal obligation* for the purposes of FRS 12. Clearly, in many instances, whether or not a company is liable for such person's injuries may be the subject of dispute. Any legal claim made by such person may well be subject to a vigorous defence by the company. In such contentious circumstances could one say that a 'present obligation' is owed? FRS 12 addresses this issue directly[38] by using the example of a law suit.[39] In such circumstances a present obligation is owed where 'taking account of all available evidence, *it is more likely than not* that a present obligation exists at the balance sheet date' (emphasis added).[40] FRS 12 notes that 'available evidence' would include expert opinion regarding the likely outcome of the litigation. Accordingly, even where the company's litigation and public posture adamantly denies any responsibility to an involuntary creditor, as

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[30] S.836(1)(b) CA 2006.
[31] S.831(3) CA 2006.
[32] S.841(2) CA 2006.
[33] Financial Reporting Standard, *Provisions, Contingent Liabilities and Contingent* Assets (Accounting Standards

far as the company's financial statements are concerned accounting standards

currently the case, being disclosed in the notes to the financial statements.[45] The IASB and ASB exposure drafts propose that the lower probability of payment will be incorporated in the amount of the recorded liability.[46] If such an approach is adopted by the IASB and the ASB both higher and lower probability creditors will receive recognition by the financial statements, increasing the scope for existing and potential involuntary creditor claims to decrease net-assets and distributable

value from debtholders also increases.[48] These incentives to expropriate value increase as the funds the shareholders have invested in a company decrease, as they have less to lose and more to gain from riskier investments. Choper, Coffee and Gilson, drawing on the seminal work of Black and Scholes,[49] describe this incentive structure in terms of option pricing theory, where shareholders are viewed as holders of an option to purchase the company from the debt holders when the option is in the money (the value of the company exceeds the value of the debt). They note that 'option pricing theory provides that increasing the variability of the [value of the] underlying asset increases the value of the option'.[50]

protection on these grounds would, however, be to deny them what sophisticated voluntary creditors choose to rely on. Financial covenants in the UK, for example, are often linked to accounting based targets.[55] Although direct distribution restrictions are more common in the United States than in the UK,[56] indirect distribution restrictions such as broadly defined accounting-based net-worth provisions[57] are often included in UK debt contracts and have largely the same effect.[58]

Protecting the Constituency

As is well known, and set forth in terms of option pricing theory above, one effect of limited liability is that when a rational company assesses the expected value[59] and the required return from an investment no account need be taken of possible

rule-effects occupy an empty room. English law is wedded to a commitment to separate legal personality that provides no scope for piercing the veil to hold shareholders, even a 100% shareholder, liable to involuntary creditors *because they are involuntary creditors*.[76] No mandatory regulatory mechanism, such as mandatory insurance or a priority in bankruptcy rule counteracts these skewed incentives.[77] Involuntary creditors as a constituency continue to get a poor deal from the regulatory settlement that enables business to be conducted through the corporate form.[78]

Furthermore, this assessment of significance for involuntary creditors must be placed in the context of the significance of the distribution rules for adjusting creditors. How effective are these provisions in actually protecting adjusting creditors from credit default? The nature of the regulatory benefits themselves are identical to those identified above in relation to existing involuntary creditors: by limiting the ability of companies to distribute funds to shareholders they provide qualified reduced bankruptcy risk[79] and reduce the shareholders / managers incentives to expropriate value through excessive risk taking. As noted above, the extent of the benefit, and the price that adjusting creditors would be willing to pay for this benefit, varies according the company's capitalization. In contrast, the benefit for involuntary creditors varies as a function of the size of the claim relative to company's accumulated net-profit or net-asset status. That is, for adjusting as well as for involuntary creditors the extent to which distribution regulation provides protection is a function of an external variable rendering those benefits erratic and uneven in application. As noted above, several scholars recognise that these adjusting creditor benefits are indeed variable in application and, accordingly, argue that the rules should either be default rules or left to private ordering to incorporate them into debt agreements.[80] This makes sense where creditors can adjust to make use of, and pay for, the rules only where they make a difference. But for involuntary creditors to abolish them is to remove any scope for their beneficial application. To make the rules default-rules is to render

THE DISTORTION DRIVER

DISTORTION AND THE SOLVENCY SOLUTION

If distribution regulation protects only those creditors who can adjust to a company's actual legal capital and if, in practice, those adjusting creditors do not value distribution protection organized around the legal capital threshold then the case for reform is straightforward. If, however, as is submitted by Part II of this article, a case is made that the distribution rules provide variable but at times significant benefits for involuntary creditors then an alternative case for reform must be made. Although *not* accepting that distribution rules offer significant benefits for involuntary creditors, the Interdisciplinary Group's analysis of distribution regulation offers such an alternative case.

Standard the company must recognise on its balance sheet defined benefit pension deficits calculated on an actuarial basis.[83] As has been widely reported,[84] many companies have recently found their pension funds to be in considerable deficit. The recognition of these liabilities has had a significant detrimental impact on many companies' balance sheets, in worst cases placing them in technical insolvency[85] with assets less than liabilities. These companies, however, may remain cash-strong and successful companies who would have no difficulty in paying debts today and as they arise in the foreseeable future. As creditors are concerned with being paid, regulations that prevents asset distributions to shareholders when this creditor concern is in no way jeopardized appears pernicious and requires justification.[86]

According to the Interdisciplinary Group, the distortions generated are not justified by the benefits provided by existing distribution regulation, which they view as largely ineffective as a creditor protection device.[87] Consistent with Armour's position set forth above, the Interdisciplinary Group views the ability of creditors to rely on and adjust to the existing distribution rules in light of a company's legal capital as crucial to the rules having practical value.[88] The fact, therefore, that the available empirical evidence suggests that they are not in practice 'relied upon by creditors'[89] (and certainly not by involuntary creditors[90]) renders them of 'insufficient value'[91] to justify the distribution distortions they generate. The Group argues that a creditor's 'core' interest is in a company's solvency – its ability to satisfy the creditors' obligations.[92] Involuntary creditors' interests are, they note, 'essentially a fair prospect of solvency'.[93] The solution, therefore, is to disconnect distribution regulation from the financial statements.[94] The focus of regulation, they submit, should be on ensuring that companies have the flexibility to make distributions when the company's immediate and future solvency is not in question. Accordingly, a company should be permitted to make

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[83] *FRS 17: Retirement Benefits* (ASB, 2000), at [37].

[84] 'Pension deficits almost equal company profits' (21 February 2003) *Financial Times*.

[85] Interdisciplinary Group Report, n 81 above, 960.

[86] It is important to understand, however, that regardless of distribution regulation, *FRS 17* may drive dividend reduction in cash flow positive companies where available funds are used to address the deficit. Other pressures encourage compani0( )]TJce comaT/TT0 1 nDC BT/TTs wh-4(lin)-4(ary Gb3(u)2(v4TJ0.0 /P <MCIDfion i4moTc 0.0a

a distribution provided that directors can certify the solvency of the company for the foreseeable future:

> The directors should be required to reach the view that *for the reasonably foreseeable future, taking account of the company's expected prospects in the ordinary course*

balance sheet putting the company in technical insolvency and preventing any distribution. They do not, however, affect the company's current or medium term

be serious concerns about long term solvency, it may, given the company's product line and research and development activity, be reasonable for a director to conclude that the company would be in a position to negotiate and settle future claims, even if at the time the claims are made in the future this turns out not to be the case. Such a solvency assessment is a business judgement and UK courts have typically treated such judgments deferentially.[99] Furthermore, a carefully crafted record supporting the assessment of reasonableness of the certification is likely to

Third, the actual time frame within which directors have to think about solvency under a *reasonably foreseeable future test* may be curtailed by the limitation periods applicable to any action that could be brought against the director in relation to an unlawful dividend. Any action based on breach of trust[103] would be subject to a six year limitation period[104] unless it can be demonstrated that the directors acted fraudulently.[105] Actions based upon breach of duty of care are also subject to a six year limitation period.[106] This period may be extended if it can be demonstrated that the company was not aware of the breach until a date subsequent to the unlawful dividend,[107] in which case it will be extended to three years from that date. However, given that the board of the directors is the primary agent of the company and would have unanimously[108] approved of the solvency statement, it is unlikely that the company will benefit from this extension.[109] In relation to breach of duty, pursuant to section 32(2) of the Limitation Act 1980 the six year period will not run if the directors are found to have deliberately concealed the breach, and they will deemed to have deliberately concealed the breach if they *deliberately* breach the duty 'in circumstances that are unlikely to be discovered for such time'. Whilst under the hypothetical case of the pregnancy healthcare drug the breach will certainly not be discovered for some time, the burden of demonstrating a *deliberate* breach is a very high one, that is unlikely to be fulfilled in a company that can make a plausible, even if *unreasonable*, long term business case that the involuntary creditor obligations will be met. Arguably, therefore, the law of limitation periods reduces an open ended 'reasonably foreseeable future' solvency test to six years. Accordingly, a solvency test, whether based on *either* a fixed-time period as in capital reductions under the Companies Act 2006 *or* based on solvency for the reasonably foreseeable future as proposed by the Interdisciplinary Group, could enable distributions to be made where there exist substantial long-tail claims that the current regime would prohibit. The constituency of involuntary creditors, were they capable of acting collectively, would, therefore, object to these reform proposals.

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[103] See *In re Exchange Banking Company (Flitcroft's Case* (1882) LR 21 Ch.D. 519) suggesting that an action for unlawful dividend is based on breach of trust.

[104] Section 21 (3) Limitation Act 1980. See generally, the Court of Appeals judgment in *Gwembe Valley Development Company Limited* v *Koshy* [2003] EWCA Civ 1048.

CONCLUSION

If the function of UK distribution regulation is to maintain the legal capital account as an undistributable reserve, then its natural constituency is the adjusting creditor. Recent commentary operating though this capital maintenance lens has demonstrated that if the function of distribution regulation is to protect adjusting creditors then it is ineffective and unnecessary: to the extent sophisticated creditors rely on such protections they could negotiate for them in the absence of