Morgan Lewis

alert

business & finance lawflash

12 November 2013

UK Capital Maintenance Principle May Restrict Damages Awards

Obiter dicta by High Court suggests that damages may not be available as a remedy where an English company breaches a contractual obligation and performance of that obligation would have required a breach of the "capital maintenance" principle.

On 24 May, in *Abbar and another v Saudi Economic & Development Company (Sedco) Real Estate Ltd. and others*, the English High Court suggested that damages could not be awarded for breach of contract when the contract could only be performed in a manner that violated the “capital maintenance” principle of English company law.[1] The court suggested that an award of damages in such circumstances would itself involve a breach of this principle and would therefore be unlawful. As a result, shareholders should consider carefully the nature of any provisions contained in any shareholder or investment agreement designed to allow a shareholder to exit its investment since, where these may require a company to make a return of capital, it is possible that such provisions may not entitle a shareholder to compensation in the form of damages in the event that the company fails to perform its obligations.

Capital Maintenance Principle

Under English law, an English company incorporated under the Companies Acts may make a distribution to its shareholders (by dividend or other method) if it has sufficient distributable reserves available. A company’s distributable reserves are its accumulated, realised profits (so far as not previously distributed or capitalised) less its accumulated, realised losses (so far as not previously written off in a duly made reduction or reorganisation of capital). Any other distribution made by a company will be considered to be a distribution of capital and will be unlawful unless specifically permitted by statute. This concept is known as the “capital maintenance” principle. Although a payment by a company to a shareholder is not always classed as a distribution, payment will be considered to be a distribution where a shareholder receives money “in respect of its shareholding”. The Companies Act 2006 lists the following exceptions to the capital maintenance principle:

- A bonus issue of fully or partly paid shares
- A reduction of capital in accordance with the relevant statutory provisions
- The redemption or purchase of shares in accordance with the relevant statutory provisions
- A distribution in a winding up

Abbar Decision

In *Abbar*, a shareholder claimed that the company was obliged, under the investment agreement pursuant to which the shareholder had originally subscribed for shares, to sell a development site and subsequently distribute the net proceeds to investors within a certain period. The shareholder alleged that the company’s failure to do so constituted a breach of the investment agreement. The company had been set up specifically to acquire the site, and it represented its sole or principal asset.

The High Court, however, held that no such contractual obligation was owed. Additionally, the court noted that,

1. View the court’s decision at http://www.bailii.org/ew/cases/EWHC/Ch/2013/1414.html.

 © 2013 Morgan, Lewis & Bockius

even if the obligation had existed and had been breached, an award of damages would not have been granted because such a distribution would have been an unlawful return of capital by the company.

The court noted that the shareholder had alleged that the company was obliged to distribute the proceeds from the sale (which would have constituted substantially all of the assets of the company) whether or not the site was sold at a profit and that the obligation to distribute was not solely limited to any profit made on the sale. As a result, the court commented that any such distribution would necessarily have involved a distribution by the company out of capital. It therefore would have been unlawful unless it were made by one of the legitimate means by which capital can be returned to shareholders under the capital maintenance principle rules. The court went on to say that an award of damages to a shareholder for a failure by a company to make a distribution of capital is also a return of capital and noted that the statutory provision of the Companies Act 2006 dealing with the redemption and purchase of shares by a company excludes damages as a remedy for breach. As a result, any remedy sought by a shareholder in such circumstances would have to be structured in a way that did not breach the capital maintenance principle.

Conclusion

It is not unusual for investment agreements or shareholders' agreements to include provisions, typically relating to the ability of shareholders to exit their investments, whereby the company is required to take some action (such as buying back a shareholder's shares) that, under certain circumstances, would constitute a return of capital. There have always been concerns as to what would happen where a shareholder sought to enforce such a provision but where the company would not lawfully be able to perform its obligations as a result of the capital maintenance principle, as well as what the courts would do in these circumstances to enforce such a clause. The *obiter* comments by the High Court in *Abbar* support the argument that damages may not be available to compensate a shareholder for loss in the event a company fails to comply with its obligations under such provisions.

Contacts

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis lawyers:

London

Iain Wright	+44 (0)20 3201 5630	iwright@morganlewis.com
Gemma Formby	+44 (0)20 3201 5574	gformby@morganlewis.com

About Morgan, Lewis & Bockius

With 25 offices across Europe, the United States, the Middle East, and Asia, Morgan Lewis provides comprehensive litigation, corporate, transactional, regulatory, intellectual property, and labour and employment legal services to clients of all sizes—from globally established industry leaders to just-conceived start-ups. Our international team of lawyers, patent agents, benefits advisers, regulatory scientists, and other specialists—more than 1,600 legal professionals total—serves clients from locations in Almaty, Beijing, Boston, Brussels, Chicago, Dallas, Dubai,* Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Moscow, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

*In association with Mohammed Buhashem Advocates & Legal Consultants

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some jurisdictions. Please note that the prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change. © 2013 Morgan, Lewis & Bockius. All Rights Reserved.