Legal responses to corporate undercapitalisation: towards a proactive approach?

ABSTRACT

The ability to mobilise capital by attracting investments from the public was one of the driving forces in the development of the modern company. Companies finance their business operations through a combination of equity and debt. The choice between equity and debt financing depends on a variety of factors ranging from macro-economic factors such as the relative abundance or scarcity of capital, the costs of raising different types of financing and the tax treatment of debt and equity financing.

A notion of undercapitalisation is recognised in several disciplines of the law, including tax law, company law and corporate insolvency law. As these disciplines have different purposes they employ different definitions of and attach different consequences to undercapitalisation. They employ mostly reactive or ex post strategies. Yet the recognition of the concept implies that there is an ideal standard according to which corporations should be capitalised - an idea of adequate capitalisation. The purpose of this lecture is to analyse some of these responses in search for common ground that may serve as the basis for a more proactive solution or guiding principle.

Company law does not generally prescribe to what extent equity and debt financing should be relied on or, for that matter, the value of the total assets that a company should have. Some jurisdictions do prescribe a minimum capital or pay attention to the manner in which a company is to be financed, but such measures tend to have a limited impact beyond the incorporation phase of a company. Limited attempts are also made to scrutinise proposed financing methods when the continuance of a distressed company is under consideration. Although undercapitalisation is an important factor in imposing personal liability for the debts of a company based on the so-called veil-piercing cases, it is not generally regarded as an independent ground for the disregarding of corporate personality. This complicates formulation of a proactive approach.

In international tax law, transfer pricing rules function as anti-avoidance measures that prevent the abnormal allocation of income and expenses between related or connected persons aimed at obtaining a tax benefit. These measures include thin capitalisation rules targeting the use of disproportionate levels of debt in relation to equity. They prevent the deduction of excessive interest payments in respect of debt financing by connected persons. While they treat debt financing as if it was in fact equity financing, this is done only in relation to the tax consequences. Nevertheless, it seems that tax law can provide useful guidance in the formulation of a concept of inadequate capitalisation.

Corporate insolvency law provides several responses to undercapitalisation, including the equitable subordination of debt and the recharacterisation of debt as equity. While the requirements for and consequences of these two responses differ,
both apply in respect of financing provided by insiders such as holding companies, controlling shareholders and certain creditors. The degree of correspondence between the types of financing subjected to these insolvency solutions and the transactions targeted by thin capitalisation rules is evident. The regulation of insider loans thus appears to be a good starting point in addressing the problem of corporate undercapitalisation. Insolvency law in Germany and in the United States of America provide useful guidance for the design of a South African approach.
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Introduction

The ability to mobilise capital by attracting investments from the public was one of the driving forces in the development of the modern company. Corporate personality has been described as a device to designate a specific pool of accumulated assets for a specified purpose and achieving this separation as the only essential purpose of company law. These observations relate to the company's capital in the sense of its total own funds comprising contributed as well as accumulated capital.

Mega-corporations with “economies” larger than those of many countries attest to the success of this institution. These companies would not have been able to attract capital were it not for the corporate form. But at the other end of the spectrum we find small companies in which even a single entrepreneur invests a limited sum. Glasbeek refers to this dichotomy as the “multiple personality disorder” of corporations. The justification for recognising small companies, in particular those with a single shareholder, has often been questioned and the wisdom of extending the advantages of limited liability to their shareholders criticised.

Companies finance their business operations through a combination of equity and debt. Equity comprises share capital and retained earnings while debt financing can be obtained through issuing debt securities (known as debentures or bonds), by taking up long- or short term loans and utilising credit facilities. Company law does not generally prescribe to what extent equity and debt financing should be relied on or, for that matter, the value of the total assets that a company should have. The choice between equity and debt financing depends on a variety of factors ranging from macro-economic factors such as the relative abundance or scarcity of capital, the costs of raising different types of financing and the tax treatment of debt and equity financing.

The title of this lecture assumes that there is such a thing as undercapitalisation or inadequate capitalisation. Implicit in this is also that there is an ideal standard according to which corporations should be capitalised - a notion of adequate capitalisation. However, it is not an easy task to determine what this may be.

A notion of undercapitalisation is recognised in several disciplines of the law, including tax law, company and corporate insolvency law. As these disciplines have different purposes they employ different definitions of and attach different consequences to undercapitalisation. They employ mostly reactive or ex post strategies. The purpose of this inaugural lecture is to analyse some of these responses in search for common ground that may serve as the basis for a more proactive solution or guiding principle.

The concept of undercapitalisation relates to an inadequate level of equity financing, or asset insufficiency. Its significance is linked to the protection of company funds. This separate estate of a company is subject to two important rules: a ‘priority rule’
and a ‘liquidation protection rule’. The priority rule entails that the creditors of the company enjoy preference over the personal creditors of the shareholders in respect of the company’s assets. Liquidation protection means that the shareholders cannot withdraw their ‘share’ of company assets at will, as this would amount to a partial liquidation and to the shareholders jumping the queue. Also, the personal creditors of the shareholders have no claim to a proportionate part of the company’s assets, although they may lay claim to the actual share owned by shareholders and attach it in execution. Hansmann & Kraakman term the pattern of creditors’ rights that arises when both these rules apply ‘strong form’ legal personality and view it as the converse of limited liability: while limited liability protects the assets of the shareholders against claims by the company’s creditors, strong form legal personality protects the assets of the company against claims by the creditors of the shareholders. Limited liability results in ‘defensive asset partitioning’ while the shielding of the company’s assets against the shareholders and their creditors - the result of separate legal personality – results in ‘affirmative asset partitioning’.

The relationship between shareholders and creditors, and the function of equity capital as a ‘risk allocation device’ is well illustrated by the concept of gearing or leveraging in terms of which the ratio of loan capital to share capital will influence the potential return to shareholders and also the potential risk faced by creditors. Debt is incurred at a fixed or predictable cost to the company and will be cheaper than share capital in times when the company prospers because unlike shareholders expecting a return on their investment, the creditors cannot participate in the profits beyond their specified returns. When the company is facing financial difficulties, however, the risk of default faced by creditors will increase. Excessive leveraging has several further implications, including decreased creditworthiness of companies leading to decreased economic growth, increased outsider control and increased risk of failure.

Responses in company law

Assuming that the function of company law is to provide the structure for the accumulation of a separate pool of assets – the equity of a company – it is perhaps surprising that company law does not necessarily impose ex ante rules regarding the minimum size of that capital. In certain jurisdictions, however, a minimum capital is indeed prescribed.

Minimum paid-up share capital

In terms of the European Union Second Company Law Directive of 1977 member states must require public companies to have an allotted share capital equivalent to at least 25 000 euros. (At least a quarter of this must be paid up upon incorporation of the company.) This minimum amount has never been increased and is generally perceived to offer very little protection to those dealing with companies. Its main role is said to be the discouraging of frivolous incorporations. This conclusion is
reinforced by the absence of a continuing obligation to maintain assets equivalent to the minimum capital, although companies have to convene a shareholder meeting to discuss the future of the company when the value of the company's net assets have fallen to a level below 50% of its called-up share capital.

While EU member states are not obliged to prescribe minimum share capital requirements for private companies, some do, including the Netherlands, Belgium and Spain. France recently reduced its minimum capital requirement for private companies to 1 euro while Germany, which in principle requires a minimum, introduced a special form of private company, known as an 'Unternehmergesellschaft (haftungsbeschränkt)' (UG) or Limited Liability Entrepreneurial Company, that can be incorporated without share capital but has to build up the required level of capital over a period of time. [It is significant that the lack of minimum share capital is addressed through a restriction on the distribution of profits to shareholders to a maximum of 75% of annual profits and the requirement that at least 25% of annual profits must be retained in the company and credited to a statutory reserve.]

Companies can generally be formed without any scrutiny of how they will be financed. However, under s 172 of the 1973 Companies Act it was a requirement for the issuing of a certificate to commence business that the directors had to declare that the company's capital was adequate for its purposes and its business or, if it was not, that they state the reasons for this and explain the manner and extent to which the company will be financed from alternative sources.) Regulation 74 under the new Companies Act requires the inclusion of a similar declaration in a prospectus in respect of the issued capital of a company the securities of which are being offered to the public.

Restrictions on distributions

Company law rules that restrict the distribution of corporate funds to shareholders subject to compliance with a solvency and liquidity test are aimed at giving effect to creditors’ prior right to receive payment. While these rules do not impose a positive obligation on the company to maintain specific levels of solvency, they nevertheless attach consequences to a particular form of undercapitalisation.

Piercing of the corporate veil

Courts have been prepared to disregard the proverbial corporate veil and hold the controllers of a company personally liable for its obligations in a range of circumstances. One of the factors often taken into account is initial undercapitalisation of the company, referring to the situation where a company is incorporated with a share capital that is patently insufficient for its purposes.
However, it seems that this factor by itself is not sufficient and would have to be accompanied by further indications of abuse such as a failure to comply with corporate formalities. The decision of the Cape High Court in *Airport Cold Storage (Pty) Ltd v Ebrahim & Others* (2008) 2 SA 303 (C) is a good example of this approach.

A strong argument against veil-piercing for undercapitalisation is that voluntary creditors can establish the size of the contributed capital with relative ease and must be taken to have agreed to extend credit to the company based on whatever capital it had. This argument explains why some commentators put forward undercapitalisation as a relevant ground for piercing the veil in tort cases only.

**The continuance of distressed companies**

From time to time a court may have to decide on the continued existence of companies or on the way in which their affairs will be conducted in future. The court could be asked to sanction a scheme of arrangement or compromise, to grant a judicial management order or place a company in business rescue. In this regard it is not uncommon for courts to consider the proposed financing methods. However, it seems that courts are reluctant to prescribe how companies should be financed and may thus allow the continued operation of companies despite criticism of the chosen methods. See, eg the remark of Horn AJ in *Lordan NO v Dusky Dawn Investments (Pty) Ltd (In Liquidation) (Pearmain and Another Intervening)* 1998 (4) SA 519 (SE):

> The offer contains the usual subordination clauses. However, a worrying factor is that the capital sum consists of a loan provided by the offeror to the company. This is detrimental as it (a) increases the liabilities and (b) pushes the company further into insolvency. It is so that the loan is subordinated but it remains a contingent liability. **The amount paid in terms of the offer should preferably take the form of an investment which enhances the share structure and capital of the company.** Such an investment would comprise an asset which in turn would enhance the company's creditworthiness for future funding. In my view, to provide capital in the form of a loan defeats the purpose for which the s 311 compromise procedure is envisaged. It was argued that the loan formula is preferable from an income tax point of view. Whatever the tax position may be, the primary consideration should be the restoration of the company rather than what can be gained from the fiscus. Liquidators, before recommending the acceptance of an offer should give good and valid reasons why funding of a company in terms of a compromise is to be done in the way of a loan rather than by way of capital injection or other form of investment which would strengthen the asset base of the company. I am not alone in my thinking in this regard. In *Cooper v A & G Fashions (Pty) Ltd: Ex parte Millman NO* (supra) Conradie J expressed similar sentiments.
The court nevertheless sanctioned the compromise. However, in *Cooper v A & G Fashions (Pty) Ltd: Ex parte Millman NO* 1991 (4) SA 204 (C) the court refused to sanction a compromise because the company was to be financed through interest-bearing debt and the interest payments were not subordinated. The court remarked that the restructuring of a company’s share capital was the most acceptable method of refinancing companies and that debt financing should be used only if convincing reasons existed.

Similarly, in *Griffin v Edwafin Investment Holdings Ltd; Chaplin v Griffin and Another; Stapleton and Others v Edwafin Investment Holdings Ltd and Others* (1630/2009 [2009] ZAKZPHC 78; 366/2009;3656/2009) [2009] ZAKZPHC 20; (22 May 2009) the court refused to grant a judicial management order because it was unlikely that the company would be able to attract new capital.

**The response of tax law**

The incidence of taxation is one of the main factors influencing financing decisions of companies. It stands to reason that tax legislation can be designed with a view to encouraging specific behaviour, including specific financing decisions.

There is a substantial degree of convergence in different tax jurisdictions with respect to the tax implications of debt and equity financing. A company may deduct interest on debt financing from its income while the recipient has to include the interest as income. Dividends paid to shareholders are not deductible in the hands of the company. Dividend payments are usually taxed in a special way that recognises the fact that the company has already been subjected to tax on its income (and could not deduct the dividend payments). In short, where corporate taxes are perceived to be high, debt financing will be an attractive option. High personal taxes favour equity financing.

In South Africa, the deductibility of interest payments is subject to the general deduction formula which means that interest will be deductible if it is an expense actually incurred in the production of income. In *Ticktin Timbers CC v CIR* 1999 (4) SA 939 (SCA) the taxpayer, a close corporation, was prohibited from deducting interest payments to its member because the accumulated funds of the corporation was distributed to the member and then advanced back to the corporation in the form of an interest-bearing loan. The court held that the interest expense was not incurred in the production of income as the purpose of the transaction was to provide the member with interest income from which he could satisfy his personal obligations. One may rightly ask whether the answer would have been the same had the funds been distributed to the member and the corporation financed through an external loan.
The tax differences arising from debt and equity financing become far more acute in the context of cross-border transactions where interest is deducted in jurisdiction A is not taxable in the hands of the recipient in that same jurisdiction. The deduction is then not offset by tax collected on the receipt of interest and funds effectively flow out of the country untaxed. The exemption of interest payments to non-residents (s 10(1)(h) of the Income Tax Act) is relevant in this regard. It must be noted that a withholding tax on interest paid to non-residents is soon to be introduced.

It is common for tax laws to address this problem where a corporate group or connected persons are involved as this relationship allows exploitation of the normal rules. So-called ‘transfer pricing rules’ function as anti-avoidance measures and operate by preventing the abnormal allocation of income and expenses between related or connected persons aimed at obtaining a tax benefit. In particular, thin capitalisation rules target the use of disproportionate levels of debt in relation to equity. They prevent the deduction of excessive interest payments in respect of debt financing by connected persons. While they treat debt financing as if it was in fact equity financing, this is done only in relation to the tax consequences.

What is regarded as excessive debt financing can be determined in different ways, but it is quite common to prescribe a specific ratio of debt to equity which will be regarded as excessive or which, if adhered to will at least operate as a so-called ‘safe harbour’.

This approach is evident in the provisions of the South African Income Tax Act, as interpreted in accordance of Practice Note 2, that apply in respect of years of assessment that commenced up to 30 September 2011. It is only when the debt to equity ratio exceeded 3:1 that the thin capitalisation rule of s 31(3) can apply. Non-adherence to this ratio does not mean that interest payments are undeductible – a taxpayer could still show that the interest was not excessive. Section 31(3) of the Income Tax Act basically relates to financing supplied by a non-resident to a connected resident or a resident in which the non-resident investor has a direct or indirect interest entitling it to participate in 25% or more of the dividends, profits or capital of the resident or 25% or more of the voting rights in it. The Commissioner may disallow the deduction of interest to the extent that the financing is regarded as excessive in relation to the fixed capital of the resident.

However, the specific thin capitalisation provision will no longer apply in respect of years of assessment commencing on or after 1 October 2011. The deductibility of interest payments by thinly capitalised companies will in future be determined in accordance with the arms length principle. Where any transaction between a resident and a non-resident who are connected persons contains any term or condition that differs from that which would have existed if the parties were independent and dealing at arms length and any of the parties obtained a tax benefit
as a result of the transaction, the Commissioner has the power to determine the taxable income of the parties as if the transaction was entered into on arms-length terms and conditions.

**Responses in Corporate Insolvency Law**

*Subordination and recharacterisation of insider loans*

Bankruptcy courts in the USA developed the doctrine of equitable subordination under their general power to ensure an equitable distribution of insolvent estates. Also called the Deep Rock doctrine, after the name of the insolvent subsidiary in *Taylor v Standard Gas & Electric Company* 306 US 307 (1939), it involves subordinating the creditor claims of parent companies or controlling shareholders to the claims of outside creditors. The doctrine finds application where the subsidiary or debtor company is undercapitalised.

The principle has been codified in s 510(c) of the US *Bankruptcy Code* 11 U.S.C. (2003). Subordination will be ordered where the insider creditor who asserts a claim in the insolvency had engaged in inequitable conduct which either caused injury to the outside creditors or resulted in the insider obtaining an unfair advantage over other creditors. It is also required that subordination of the claim must not be inconsistent with the applicable insolvency legislation. Undercapitalization is an important factor in determining inequitable conduct.

In addition, courts in the USA also recognise the principle of recharacterisation of insider loans. The difference is that a recharacterised loan is regarded for all purposes as equity of the company while subordination simply changes the priority of the claim. While this may have little practical effect in an insolvency, the difference in requirements is significant. Equitable subordination requires proof of wrongdoing by the creditor and harm caused to outside creditors. The claim is subordinated to the extent that the insider creditor caused harm to outside creditors. However, recharacterisation involves an enquiry into the substance rather than the form of a transaction. ‘Debt’ may be characterised as equity irrespective of any wrongdoing on the part of the creditor. The entire debt will be treated as equity. In characterising an advance as debt or equity court consider the terms of the financing, eg whether there is a fixed rate of interest, fixed repayment terms, contractual subordination and security as well as whether the company is undercapitalized and whether it is able to obtain outside financing. Transactions entered into on terms that are not arms length are more likely to be recharacterised as equity.

German law also recognises subordination of insider loans. Provisions have existed in respect of private companies since 1980 (s 32 (a) and (b) of the GmbH Gesetz), these have been replaced by more comprehensive rules applicable to all companies and contained in the insolvency legislation (InsolvenzOrdnung or InsO). The
previous rules applied only to financing provided (or continued and not called up) by a shareholder during a financial crisis. A financial crisis included insolvency, illiquidity and credit-unworthiness, i.e. the company is unable to obtain a loan from a reasonable outsider on the same terms. Such a loan could not be repaid during the crisis and was treated like equity in an ensuing liquidation.

The new rule in s 39 of the InsO applies to all companies and to all shareholder loans, except those made by minority shareholders or prospective shareholders. It does not prevent the repayment of shareholder advances during times of crisis, although payments within a specified time prior to liquidation could be set aside. However, it prescribes automatic subordination if the company is liquidated.

**Common ground for a proactive approach?**

Most of the legal responses ensue when the risk of corporate activity is shifted to creditors in a way which is perceived as unreasonable. There is one exception, namely tax law. Tax law is concerned with state revenue and its reaction to inadequate capitalisation is designed primarily to safeguard the state’s financial interest.

It seems that not all debt is created equal. In the context of undercapitalisation insider loans are singled out for special treatment in Tax Law as well as Corporate Insolvency Law. The unease regarding shareholder loans comes a long way. In fact, the Salomon case – the seminal decision on separate corporate personality – dealt with a secured shareholder loan and a claim by outside creditors that it should not compete with their claims. These creditors were unsuccessful in Salomon. However, when a similar situation presented itself in the Deep Rock case in the USA, the doctrine of equitable subordination was born. Faced with the problem of insider loans in TJ Jonck BK h/a Bothaville Vleismark v Du Plessis NO 1998 (1) SA 971 (O) the court found that the member of the close corporation had abused the separate personality of the corporation and had conducted its business recklessly by having a notarial bond registered in his favour and perfecting it shortly before placing the corporation in liquidation.

The regulation of insider loans is a good starting point in addressing the problem of corporate undercapitalisation. Insolvency law in Germany and in the United States of America provide useful guidance for the design of a South African approach.