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The Capital Maintenance Doctrine Under Nigerian Company Law

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Abstract

The rules regulating the maintenance of capital under Nigerian corporate law have not departed much from the common law position enunciated in Trevor v Whitworth. Companies are restricted from reducing capital, buying back their shares, paying dividends to shareholders or financing the purchase of their shares, unless they meet a number of very stringent conditions that nearly negate the possibility of such transactions. These rules are still applicable despite years of epoch-making developments in business and finance. With the aim to drive reform of the capital maintenance rules applicable in Nigeria, this paper seeks to: (i) identify specific flaws in the Nigerian rules, (ii) compare these rules with the best capital maintenance rules from other common law jurisdictions, and (iii) with regard to local peculiarities, suggest specific reforms to the Nigerian capital maintenance rules. This paper adopts a doctrinal and analytical approach, using the fundamental doctrine of corporate governance that compels the protection of creditors as a background against which the Nigerian rules are analysed in comparison with rules from other common law jurisdictions. This paper finds that the historical argument that the best way to protect creditors is to hamstring companies through very restrictive capital maintenance rules is flawed and outdated. Instead of the current rules and the judicial test which they mandate, a combination of the solvency and liquidity tests is recommended as a pre-phase to capital alteration or permitting a company to finance purchase of its own shares.

1. Introduction

Capital in a general sense can be said to be the assets a firm uses to generate income. This broad definition means that capital will include assets like money, machinery and goods. However, in a narrower accounting sense, the concept of capital refers to financial resources of a company employed to generate income. The capital of the company in this sense is comprised of both debt and equity. While debt refers to loans and other forms of credit (for example, vendor finance) which are liable to be repaid, equity is the money that shareholders invest in the business. It is important to note that in relation to the capital maintenance rules which form the subject of this paper, capital refers primarily to a company's equity.

Given that most companies would readily admit the importance of capital to their business,[1] it remains helpful to answer the question: why does the quality and quantity of a company's capital matter to regulators? Based on recent history, the intuitive answer would be that regulators fear the catastrophic effects the collapse of some strategic companies could have. It is to forestall the occurrence of such collapse that the Central Bank of Nigeria periodically requires banks

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[1] See for example, the studies conducted in Okeke M. and Ene O, 'Challenges Facing Entrepreneurs in Nigeria' (2014) 3(5) *Singapore Journal of Business Economics and Management Studies* 18.

operating within the country to shore up their equity capital, in order to provide them with a significant buffer against insolvency. A similar regulatory practice is prevalent across the financial sector. This regulatory approach and consequent interventions are not limited to public companies. Therefore, despite the fact that a majority of such strategically placed companies are privately owned, countries around the world have had to bail them out in periods of threatened collapse. However, legislative interventions in less strategic sectors are not justifiable by the same explanations, and historically, such interventions have been premised on creditors' interests. Legislatures, regulators and courts have therefore deemed it important to protect creditors despite the fact that loan contracts are usually voluntary and freely negotiated. It would seem that the law protects companies' creditors because it regards them as a vulnerable class of parties in contracts. Again, the reason for this perception seems to be that creditors are viewed as external stakeholders of the company, not involved in its internal operations. When creditors lend money to companies, they do so under the express or implied condition that the money would be used for trading and the generation of future income, and it is from this income that they expect the loan to be settled. In doing this, creditors take a risk that the capital may be dissipated in the normal course of the business of the company. However, what they do not desire is for the company to deliberately dissipate its capital in a manner that would render the company incapable of meeting its loan obligations. Yet another plausible explanation for the protection of creditors through the instrumentality of the capital maintenance rules is that since under winding up proceedings, creditors' interests usually take precedence over those of equity holders, the capital maintenance doctrine merely seeks to reinforce this order of priority.[2] The capital maintenance doctrine is primarily anchored on five pillars:

(a) The rule on minimal and nominal capital requirements of the company;

(b) The rule regulating the payment of dividends or other distributions to shareholders;

(c) The rule on reduction of company's capital;

(d) The rule prohibiting the provision of financial assistance to a shareholder for the purchase of the company's shares;

(e) The rule regulating the purchase by a company of its own shares.

2. Evolution of Nigerian Company Law

It is important to briefly consider the evolution of Nigerian company law as a background to understanding the capital maintenance provisions in Nigeria. The history of Nigerian company law is intertwined with the political and legal history of the country. The first companies' legislation in Nigeria was the Companies Ordinance of 1912 which was based primarily on the United Kingdom Companies Act of 1908. This Ordinance applied only to the Colony of Lagos, until it was amended in 1917 and extended to the whole country by the Companies Amendment and Extension Act of 1917. The 1917 Ordinance was later repealed and replaced by the Companies Ordinance of 1922 which saw amendments in 1929, 1941 and 1954. The first major indigenous companies' statute was the Companies Act of 1968. However, even this statute was

[2]See s. 657(4) – (6) of the Companies and Allied Matters Act 2020 (CAMA 2020) and the Companies Winding up Rules made pursuant to the Act.

greatly influenced by the UK Companies Act of 1948. The 1968 statute was later replaced by the Companies and Allied Matters Act (CAMA) of 1990, which has been repealed and replaced by the Companies and Allied Matters Act 2020.[3]

In the years after the enactment of the 1990 CAMA, the amendments that were made were less than satisfactory, meaning that the law in this area did not reflect the enormous progress that has occurred in the area of business innovation. This is also true regarding the rules relating to capital maintenance. Although with CAMA 2020 some progress has been made, the Act still leaves much to be desired.

3. The Capital Maintenance Rule

3.1 The Rule under the Common Law

Nigerian Law on capital maintenance is largely based on the decision of the House of Lords in *Trevor v Whitworth*.[4] In this case, Whitworth had sold his shares in James Schofield & Sons Limited back to the company in 1880 by virtue of an agreement under which he was to be paid in two instalments. He received his first instalment but died before payment of the second instalment. The company went into liquidation in 1884 and Trevor was appointed liquidator of the affairs of the company. The executors of Whitworth's estate applied to Trevor for the outstanding balance of shares' purchase price. The court of first instance denied the claim but the decision was reversed on appeal allowing the claim. Trevor appealed to the House of Lords, where it was held that such buybacks were illegal and *ultra vires* the company even if permitted by the company's articles and memorandum. According to Lord Herschel:

> *If the claim under consideration can be supported, the result would seem to be this, that the whole shareholders, with the exception of those holding seven individual shares, might now be claiming payment of the sums paid upon their shares against the creditors, who had a right to look to the moneys subscribed as the source out of which the company's liabilities to them were to be met. And the stringent precautions to prevent the reduction of the capital of a limited liability company, without due notice and judicial sanction, would be idle if the company might purchase its own shares wholesale and so effect the desired result… I cannot think that the employment of the company's money in the purchase of shares for such purpose was legitimate.*[5]

It is obvious that this decision was reached in order to ensure the protection of the company's creditors. This point is further reinforced by the often quoted statement by Lord Watson in the same case:

> *Paid up capital may be diminished or lost in the course of the company's trading; that is the result which no legislation can prevent; but persons who deal with, and give credit to a limited liability company, naturally rely on 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*

[3] No. 3 2020.
[4] (1887) 12 Appeal Cas 409.
[5] *Trevor v Whitworth* (1887) 12 App Cas 409.

> *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 business.*[6]

It is obvious from Lord Watson's quoted statement above that the capital sought to be protected by the law is the company's paid up capital and/or any balance of capital owed on call by shareholders. As this paper will show, this definition of a company's capital is of minute significance to the financial health of a company. Although Nigerian law has moved, some bit away from the capital maintenance rules as enunciated in *Trevor* v *Whitworth* there remain statutory provisions that have become practically redundant in the current times.

3.2 The Rules Under Nigerian Law

3.2.1 The Rule on Minimal and Nominal Capital Requirements of the Company

The concept of authorised share capital was operational in Nigeria up till the year 2020 when it was eliminated under the new CAMA 2020, which retains the concepts of 'par value' of shares, issued share capital and paid up capital. It is necessary to point out at this stage that the minimum capital requirement of ₦100,000 for private companies and ₦2,000,000 for public companies remains trivial and cannot possibly be used as a determinant of the amount of debt which a company may incur in business.[7] This goes to prove that the basis of the capital maintenance doctrine, even under CAMA 20, which is that the issued share capital of the company informs current and potential creditors of the resources of the company, remains faulty. It is also a fact that the par value stated capital of a company only reveals historical facts regarding the company and not the current financial status of the company. These and other historical indicators are therefore not helpful in protecting shareholders from unscrupulous managers or directors.

3.2.2 The Rule Regulating Payment of Dividends or other Distributions to Shareholders

Sections 426-428 of CAMA 2020 provides for conditions under which dividends may be paid. A company may declare interim or yearly dividends but such a decision may only be taken at a general meeting.[8] The company in general meeting has power to decrease but not to increase the dividends which have been recommended by the directors.[9] Dividends may only be paid out of the distributable profits of the company.[10] A company may however not declare dividends if there are reasonable grounds for believing that the company would after the payment be unable to pay its liabilities.[11] All directors who knowingly pay or are party to the payment of dividends out of capital shall be personally liable, jointly and severally to refund to the company the amount paid.[12]The directors also have the right to recover the wrongfully paid dividends from shareholders who receive the dividends with knowledge that the company had no power to pay it.[13]

[6] Ibid 423-424.
[7]CAMA 2020 s. 27(2)(a).
[8]Ibid s.426(1).
[9] Ibid s. 426 (3).
[10] Ibid s. 427 (1).
[11] Ibid s. 428.
[12] Ibid s. 433(1).
[13] Ibid s. 433(2).

3.2.3 The Rule on Reduction of Companies' Capital

Generally, once shares have been issued, a company may not thereafter reduce its share capital under Nigerian law.[14] However, the law admits that in exceptional circumstances and through a stringent process a company may be allowed to reduce its capital: if such reduction is permitted by its articles, it passes a special resolution to that effect, and the reduction is approved by the court.[15] The permitted circumstances under which a reduction is permissible under the Act are:

(a) to enable the company extinguish or reduce the liability on any of its shares in respect of its share capital not paid up; or

(b) to cancel any paid up share capital which is lost or unrepresented by available assets; or

(c) cancel any paid up share capital which is in excess of the company's needs.[16]

Therefore, unless under special circumstances, where a proposed reduction of shares involves either the diminution of liability in respect of its unpaid share capital or the payment to a shareholder of any paid up share capital, the company must bring the notice of the application for reduction before creditors and the court is then mandated to settle a list of such creditors. The creditors so notified have a right to object to such reduction and the court has an obligation to ensure that such debt or claim is either resolved or a provision is made by the company for the settlement of same.[17]

Where the company fails to register a creditor entitled to a claim as part of the list of creditors before the court and where the company is unable to pay such a creditor in the event of winding up, every member of the company at the date of registration of the order for reduction shall be liable to contribute towards the payment of such a creditor.[18] Where the application for reduction is made before a court, the court may only grant such application if it is shown that the consent of every creditor of the company has been obtained, or that their debt or claims have been discharged, determined or secured. The reduction must also not lead to the company's share capital falling below the minimum prescribed share capital under the CAMA.[19]

There are very stringent publication and registration requirements where the court grants the order for reduction. For instance, the order must be registered with the Corporate Affairs Commission and the notice of reduction published in the manner directed by the court.[20] The company may also be directed by the court to affix the words 'and reduced' to the end of its name after reduction.[21]

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[14]Ibid s. 130(2). Share capital in this case includes the share premium account and any capital redemption reserve account of the company. See CAMA 2020 s.130 (2).

[15] CAMA 2020 s, 131(1).

[16]Ibid s. 131(2).

[17] Ibid s. 132(1) – (5). Note that the court may dispense with this requirement in special circumstances. See s. 132(6).

[18] CAMA 2020 s. 135(2) – (4).

[19]Ibid s. 133(1).

[20]Ibid s. 134(1) – (4).

[21] Ibid s. 133(2)(a) and (3).

3.2.4 The Rule Prohibiting a Company from Financing the Purchase of its Own Shares

It is unlawful under Nigerian law for a company or any of its subsidiaries to give financial assistance directly or indirectly to any person for the acquisition of the company's shares or where a person has acquired the shares in the company but has incurred a liability, for the purpose of reducing or discharging such liability.[22] Financial assistance includes gifts, guarantees, security or indemnity, loan or any form of credit and any financial assistance given by the company, thereby reducing its net assets by up to 50% or to the extent where it has no net assets.[23] Where the company is in contravention of these provisions, the company and every director in default shall be liable to pay a fine prescribed under the Companies Regulations.[24]

The common form of financial assistance envisaged is where a potential shareholder borrows funds to make an acquisition of a controlling interest in a company and uses their control to ensure that the company repays the original loan.[25] The provision of financial assistance for the acquisition of shares for the benefit of employees of the company is permitted.[26] Other exceptions include where the company lends money in the ordinary course of business provided its business ordinarily involves such lending, any act or transaction otherwise authorized by law, any court-sanctioned act done as part of a scheme of arrangement, a scheme of merger or any other scheme or court-sanctioned restructuring.[27] There is a general exception with respect to private companies subject to the conditions that the net assets of such private company are not reduced by the financial assistance it provides or where there is reduction in net assets, the assistance is paid out of distributable profits. There must also be a special resolution by the company in general meeting, approving the financial assistance in question, as well as a statutory declaration by members of the board of directors.[28]

3.2.5 The Rule Regulating the Purchase by a Company of its Own Shares.

A company may purchase its own shares as long as it fulfils certain conditions. Such buyback must be permitted by the company's articles and authorized by a special resolution of the members, which special resolution must be published in two national newspapers within seven days. Creditors or aggrieved shareholders will be entitled to file an action in court to cancel the share buyback resolution within six weeks of the newspaper publications. The directors are in addition required to file a declaration of solvency at the CAC within fifteen (15) days of the publications. The shares in question must also be fully paid up and the buyback made only from distributable profits.[29] A company may not purchase its shares if as a result of the purchase there would no longer be any issued shares of the company other than redeemable shares or treasury shares.[30] Also, a company cannot buy back more than 15% of any class of its shares.[31]

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[22] Ibid s. 183(2).
[23] Ibid s. 183(1).
[24] Ibid s. 183(5).
[25] See the 1962 Report of the Jenkins Committee
[26] CAMA 2020 s. 183(3)(b) and (c).
[27] Ibid s. 183(3)(a), (d) and (e).
[28] Ibid s. 183(4).
[29] Ibid s. 185.
[30] Ibid s. 184(1).
[31] Ibid s. 187(1).

The Securities and Exchange Commission (SEC) Rules 2013 contains rules on share buyback which are similar to those contained in CAMA 2020. Section 398 of the SEC Rules of 2013 deals with share buyback by publicly quoted companies. This section requires publicly quoted companies contemplating a share buyback to first seek the approval of SEC, providing detailed information relating to the proposed buyback including the company's latest financial statements. A company is not allowed to buy back its shares twice within 365 days, and buyback must only be made directly by the company and solely for the benefit of the company. Companies are required to make an undertaking that no voting rights would be exercised in respect of the acquired shares.[32] In addition, shares bought back must be cancelled in accordance with the provisions of CAMA.[33]Also companies must publish information relating to the size, nature, duration and potential impact of the buyback on the company's financial position in two daily newspapers before and after the buyback and the source of funding for the buyback has to be disclosed. The buyback shall be either through open market or self-tender offer.[34] For an open market buyback, the price of the shares should be at current market price and for self-tenders, the price to be determined by the Board of Directors, shall not be more than the 5% above the average calculated market price over the last five (5) days. Also for acquisitions done through the open market, the company is not allowed to use more than two stockbroking companies which must not be subsidiaries of the company. The residual debt to equity ratio shall not exceed 2:1 after the buyback. It is important to note that the equity for this purpose is only limited to shareholders' funds. Also after the buyback the shareholders' funds must not fall below any legally prescribed minimum for the line of business that the company is involved in.

4. Trends from other Jurisdictions

4.1 England

The reason for the slow pace of reform in England has been attributed to the country's membership of the European Union, which made the country subject to the broader European Union capital maintenance rules. The European Union's Second Council Directive mandates minimum capital requirements for companies within the Union and governs shareholders distribution as well as maintenance and reduction of capital.[35]

The current position of the law relating to capital maintenance in England is provided for under the Companies Act 2006 (Amendment of Part 18) Regulations 2013 which came into force on the 30th of April, 2013. English law still allows the issuance of shares at par value and requires that at least 25% of the authorized share capital of the company should be issued.[36] Public companies are required to have a paid up capital of at least GBP 50,000. There is, however, no share capital requirement for private companies.

[32]See CAMA 2020 s. 187(3).

[33]Securities and Exchange Commission Rules and Regulations (SEC Rules), 2013, s. 398. Cancellation of re-acquired or treasury shares is now only mandated as one of three(3) ways of getting rid of re-acquired shares that are in excess of 15% of any class of shares.

[34] Open (market) tender occurs where the company repurchases its shares in the open market (stock exchange), while in self tenders, the offer to buy back is made directly to the targeted shareholders.

[35] Second Council Directive 77/91/EEC of December 13, 1976.

[36] Companies Act 2006 ss. 542 (1) and 586 (1).

Companies are generally allowed to purchase their own shares. However, if the buyback is not carried out in accordance with the Act, it is void and may constitute an offence punishable with up to 2 years imprisonment.[37] The major differences between English law and Nigerian law relate to private companies. Accordingly, English law permits a private company to pass an ordinary resolution in general meeting authorizing off- market buyback.[38] Secondly, English law provides for share buybacks to be financed through some form of permissible capital payment. This system permits a capital payment to be made even after profits available for distribution have been used up provided that such payment does not exceed the lower of £15,000 or the value of 5% of the company's share capital.[39]

UK law also requires that the directors of the company make a declaration attesting to the fact that the company is solvent. An auditor's report attesting to the fact that the declaration by the directors is not unreasonable must be attached to such declaration.[40] However, this declaration is not required where the purchase is part of an employees' share scheme. Also, any proposed payment out of capital must be approved by special resolution. However, the voting rights attached to the shares which are subject to the special resolution cannot be exercised in respect of the resolution.[41] There is also a requirement for publication similar to the provision under Nigerian law. A dissenting member of the company is allowed to go to court within five (5) weeks of the special resolution authorizing capital payment, to challenge the resolution.[42] The allowable time in Nigeria is six weeks.[43] The court has powers to either cancel the resolution or vary it on such terms and conditions as it thinks fit.[44] In the event that the company is wound up within one year from the date on which a share buyback is financed out of the capital of the company, and the company's assets are insufficient to meet its liabilities, the vendor of the shares and the directors that made the declaration of solvency will be required to contribute a sum up to the amount of capital payment. In such a case, the director may escape liability by showing reasonable grounds for the opinion expressed in the declaration.[45]

Public companies are also prohibited from giving financial assistance for the purchase of their own shares.[46] Section 641(1) permits the reduction of capital of a private company's capital in certain instances. Such reduction is only allowed if permitted by the company's articles. As regards, reduction of capital, the general procedural requirements are a special resolution and a solvency statement.[47] Similar to Nigeria, dividend distributions may only be made out of the profits available for that purpose.

[37] Ibid s. 658(3).
[38] Ibid s. 694. Note that a special resolution was required before April 30, 2013.
[39] Companies Act 2006 s. 692.
[40] Ibid s. 714.
[41] Ibid s. 716.
[42] Ibid s. 719.
[43] CAMA 2020 s. 184(2).
[44] Companies Act 2006 s. 721.
[45] Ibid s. 715.
[46] Ibid s. 677 – 683.
[47] Ibid ss. 642 – 643.

The UK has therefore, to some extent, moved away from the *Trevor* v *Whitworth* decision. The progress is however not satisfactory, the reason being its past membership of the EU.[48] The EU rules have been criticized as being counterproductive as the costs associated with the EU capital maintenance rules significantly outweigh any profits accruing to creditors.[49] With Brexit, it is expected that greater reforms will follow.

4.2 Malaysia

The Malaysian Companies Act of 2016 abolished the concept of par or nominal share value and eliminated the concept of authorized share capital. The Act introduced the solvency test. This solvency test is satisfied if immediately after the reduction of capital, share buyback or financing self-directed purchase of shares:

(i) there are no grounds on which the company could be found to be unable to pay its debts; and

(ii) the assets of the company are greater than its liabilities.

Directors are also required to make a solvency statement to the effect that in their opinion the company can satisfy the solvency test.[50]

Consequently, the procedure for a company to purchase its own shares in Malaysia is satisfied where the company is permitted by its articles of association, is solvent, the share purchase is made through the stock exchange, in good faith, and in the interest of the company. Concerning corporate financing of self-directed purchase of shares, the procedural requirements also include a special resolution and approval by majority of the company. In addition, the company must receive fair value for the financial assistance given. The financial assistance must be given not more than twelve (12) months after the day on which the solvency statement was made. Malaysia's new capital maintenance rules are reinforced with greater director accountability and heavier penalties for breach.

4.2 Australia

The principal company's legislation in Australia is the Australian Corporations Act, 2001. By this Act, there are no longer minimum share capital and par value requirements for Australian companies.[51] Primarily, these rules demand that a company is solvent as a pre-requisite for reductions in share capital[52], share buybacks[53], financing purchase of its own shares[54] and payment of dividends.[55] According to the Act, 'a person[56] is solvent only if the person is able to pay all his debts, as and when they become due and payable'.[57] Directors will be personally

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[48]Eilis Ferran, 'Company Law Reform in the UK' (2001) 5 *Singapore Journal of international and Comparative Law* 516, 521.

[49] Enriques Luca and Macey Jonathan 'Creditors Versus Capital Formation: the Case against the European Capital Rules'(2001) *Cornel Law Review*86 (1) 6.

[50] S. 67A (1) and (2) of the Malaysian Companies Act 1965

[51] Australian Companies Act 2001 s. 254C

[52]Ibid s. 254C (part 2J.1)

[53]Ibid s. 254C (part 2J.2).

[54]Ibid s. 254C (part 2J.3).

[55]Ibid s. 254C (part 2J.4T).

[56] Note that a company falls within the category of 'persons' under this Act

[57] Australian Companies Act 2001 s. 95A

liable if they are in breach of this provision.[58] The Australian Corporations Act therefore requires a simplified test of solvency, fairness and disclosure by directors.[59]

4.3 United States

There is no federal corporation law in the US and therefore most of the states have their own specific laws. Efforts to harmonize the different corporate laws in the United States in 1940 led to the development of the Model Business Corporation Act (MBCA).[60] The model corporation law statute applies in a majority of the states. The MBCA was comprehensively reviewed in 1984. Under the MBCA, there are no minimum capital requirements. Concerning capital or revenue distribution, no distributions may be made to shareholders if afterwards: (a) the company will not be able to pay its debts as they become due in the normal course of business (equity solvency test); or (b) the company's total assets would become less than the sum of its total liabilities plus the sum that would be needed if the company were to be dissolved, at the time of distribution to satisfy the preferred claimants within the company (balance sheet test).

Over 50% of publicly listed companies in the United States are incorporated in the State of Delaware. Under the Delaware General Corporations Law (DGCL), there is no minimum capital requirement. According to section 151 of the DGCL, the issuance of stock without par value is permitted. At the discretion of the board of directors, considerations received for the issuance of shares are split into capital and surplus. The payment of dividends may not exceed surplus (surplus test). If there is no surplus, dividends can be paid out of net profits for the fiscal year in which dividend is declared and/or the preceding fiscal year (net profit test). Creditors are taken care of because capital is not allowed to be diminished by way of distribution beyond the amount attributable to issued and outstanding shares with preferential rights.

Section 160 of the DGCL generally permits a company to purchase its shares except where such a repurchase would cause any impairment of the capital of the corporation. Directors who flout the provisions of this section may incur personal liability and may be jointly and severally liable for the full amount paid.[61] Note however that directors who make the decision in good faith to repurchase stock under these circumstances may be protected.[62] The repurchased shares can either be held as treasury stock or cancelled. If they are held as treasury stock, they are not entitled to voting or dividend rights.

5. Deconstructing the Rules

The discussion above has distilled at least four different tests; the judicial test, the balance sheet test, the solvency test and the cash flow test. It appears that most countries operate a combination of any these four tests to arrive at a decision on whether or not to permit capital or revenue distribution.

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[58] Ibid s. 588G.

[59] Tomasic Roman 'The Rise and Fall of the Capital Maintenance Doctrine in Australian Corporate Law' (2015) 26 (5) *International Company and Commercial Law Review* 174-187.

[60] Campbell Whitney 'The Model Business Corporation Act' (1956) 11(4) *The Business Lawyer* 98-110

[61] See s. 8.33 of the Revised Model Business Corporation Act which deals with directors' liability for unlawful distribution.

[62] Ibid.

5.1 Judicial Test

Under this approach, reliance is placed on the decision of an independent arbiter who determines whether transactions fall within the narrow exceptions permitted by the law. In some cases, the judge is also granted a degree of discretion as to whether to grant the capital distribution. The biggest flaw in this rule is the supposition that either the judge understands the company's business more than its officers and directors, or that directors ought not to be trusted.

Another flaw in the philosophical basis of the capital maintenance doctrine is the assumption that there is always a conflict between the interests of creditors and that of shareholders which must always be resolved in favour of creditors given any doubts. In practice however, it is usually in the best interests of shareholders and directors to operate a company as an ongoing concern. Therefore the interests of key players usually align. Most countries have now departed from the application of this judicial test and it is recommended that Nigeria should do likewise.

5.2 Balance Sheet Test

The clearest exponent of this test is the European Union. For example, Article 15 of the Capital Directive provides rules relating to the distribution of dividends thus:

> 1 (a) Except for cases of reductions of subscribed capital, no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes.
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> [...]
>
> (c) The amount of a distribution to shareholders may not exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes.

This test takes into consideration profit and loss of prior periods for determining the ceiling for distributions and this is the biggest criticism of this approach.

5.3 Solvency Test

This test is preferred by many countries. In its simplest form, the solvency test basically seeks to determine whether the company will be able to pay its debts after it has made distributions. It differs from the strict balance sheet test which examines the company's balance sheet (a historical snapshot of the company's wellbeing) to determine if the company would be able to meet its obligations to creditors after making distributions.

5.4 Cash Flow or Liquidity Test

This test is basically that the company would continue to be liquid after distribution. Similar to the balance sheet test, the crucial measure is the preponderance of assets over liabilities. However, the advantage of this test over the balance sheet test is that it is forward looking and not historical.

Conclusion

From the foregoing discussion, it is seen that most countries have jettisoned the traditional capital maintenance doctrine, thereby allowing companies which satisfy different variations of the solvency, liquidity and balance sheet tests to reduce capital, finance purchase of their shares and pursue share buybacks. It is therefore suggested that Nigeria should, firstly, abolish the concept of par value and other redundant arrangements like the share premium account and capital redemption account. These accounts should be merged and incorporated as part of the capital of the company. The par value concept has become outdated and of no use in assessing the value of a company. There exist better accounting ratios that are better suited for this purpose.

It is also proposed that Nigeria should adopt a simplified combination of the solvency and liquidity tests. The change from the capital maintenance doctrine as is currently practiced in Nigeria to a more flexible regime will greatly aid the flow of capital into entrepreneurial endeavours. Entrepreneurs and directors are in the best position to know what is in the best interest of the company and are able to better assess risks. The law should therefore place greater reliance on their judgment. However, for the solvency test to work effectively, there needs to be proper accounting rules that allow for accurate measurement of solvency; suitable sanctions to deter responsible managers from making false claims about their company's solvency either deliberately or negligently; and effective recovery mechanisms where value is wrongfully transferred to shareholders in priority over creditors.