THE CAPITAL MAINTENANCE DOCTRINE PROVIDES ESSENTIAL
PROTECTION TO CORPORATE CREDITORS: MYTH OR REALITY?

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ABSTRACT

The capital maintenance doctrine is concerned with the rules restricting the freedom of companies to return to their shareholders funds which were originally subscribed for shares. The doctrine, which was initially developed by the courts in the 19th century, and later structured by statutes, found its roots in the House of Lords decision in *Trevor v Whitworth*. There, the courts absolutely prohibited a company from reducing its capital through the repurchase of its own shares. The prohibition was thought to be necessary to protect creditors against losses that could result from the diminution of the company’s share capital on which creditors rely for their protection. The doctrine, while restricting share buy-backs and reduction of capital provided the basis for a number of subsidiary rules regulating corporate activities that indirectly reduce the company’s capital such as, a company financing the purchase of its own shares, and the prohibition on a company paying dividends otherwise than out of profit. The central argument of the thesis is that the protection afforded creditors under the traditional maintenance of capital doctrine is a ‘mirage-like’ abstraction, because share capital provides an illusory protection against corporate failure and creditors do not rely on it either for protection or to secure their debts.

Through case and statutory law, this study provides a comprehensive analysis of the doctrine in its different aspects as applied in Australia and the United Kingdom. The study compiles, re-examines, reviews and analyses existing and proposed legislation for the protection of corporate stakeholders. It puts forward a set of specific and general proposals which recommend a shift from the maintenance of share capital to the maintenance of the assets of a limited company. Through this approach, the study suggests that future regulation of the capital maintenance doctrine can best be achieved through a dual solvency requirement, supplemented by a debt-to-equity ratio test. This model would be reinforced by other mechanisms such as the insolvent trading provisions, loan and contractual agreements and the oppression remedy provisions. This model provides a coherent and comprehensive strategy of effectively protecting creditors and shareholders in Australia and other common law jurisdictions for the 21st century.
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