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Distributing the capital premium

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Abstract: Permission of distributing the capital premiums is equivocally in Law no. 31/1990, because such premiums are not part of the profit not of the legal capital (and the mandatory reserves). Of course there is temptation to distribute such premiums, but the law incriminates fictive profit distributions. If the concept of par value of the shares would not have been in place, and shares would be issued at the market value, all such value would be registered in one account, which means that the legal nature of the premiums is closer to the legal capital than to the profit.

Key-words:
Issuance premiums, profit, loss, distribution, shareholders, reserves.

JEL Classification: *G32, G33*

Introduction

Profit allocation is a legal-accounting operation to determine the use of the positive result of a financial year for a year or for several cumulative years, which is the responsibility of the general meeting of shareholders, that is, the annual meeting, in the case of a joint-stock company. Any distribution of profits, regardless of their destination, takes place after approval based on the annual financial statements prepared by the company according to the accounting standards applicable to the type of the company, audited according to audit standards (Article 182 of the Companies Law). A company cannot combine more than one accounting standard, nor can it choose the standard on which the treatment of distributed profit is more generous.

The distribution of profit can be done only after it has been established in a real and useful way. By *reality*, it is understood to be its actual achievement, and by *utility* it is understood that distribution is made without prejudice to the creditors. The reality of profit is definitely established through the correct balance sheet drawn up at the end of the financial year. The misrepresentation by the company's management of inaccurate financial statements or inaccurate data regarding the economic conditions of the company in order to conceal its real situation is the offense provided in art. 271 lit. b) of the Companies Law. Theoretically, the financial audit might reveal and detect these inaccuracies, findings that either the management of the company needs to modify the financial statements, otherwise the censors, respectively the financial auditor, will mention this in the report presented to the general meeting. If, however, dividends are distributed from a fictitious profit, undistributable or in the absence of a financial situation or contrary to its verified results, the directors or managers of the

company are responsible for the offense provided for in Art. 272¹ lit. b) of the Companies Law, the dividends thus distributed being a loss to the company, in our view this Article being a partial application of the previous article, i.e. when the members of the management of the company, as the persons responsible for drawing up the financial statements, knew of the existence of irregularities(drafting being in their charge), for example hiding data that would have altered their form (such as debt resulting from certain contracts or litigation, substantial fines, etc.) or presenting unrealistic information on the basis of which they were drawn up financial situations. The offense provided in art. 272¹ lit. b) of the Company Law applies independently when the distribution is made from the undistributable profit, as in the legal reserves, in the latter case the distribution being unprofitable, made in the fraudulentness of the creditors, since the legal reserves have the exclusive role of supplementing the legal capital, of losses, providing the social capital together with the legal capital. Criminal liability of censors or auditors only intervenes if they have known and validated the financial statements drawn up on the basis of false data, otherwise they first check whether the treatment of the accounting records was made in accordance with the applicable standards. In conclusion, although dividends are distributed by the general meeting of the company, the shareholders are not liable as a result of their voting based on financial statements drawn up by the management of the company. Besides the criminal liability, the members of the management of the company are primarily civil, according to art. 155 of the Companies Law, the liability not being removed from the fact that the financial statements were approved and they were discharged (Article 186 of the Companies Law).

Clearly, examples of illegal distribution, when profit is unrealistic, only "on paper", would be the following: (i) the entry on the balance sheet of fictitious operations that lead to an income (and furthermore a profit) where it does not actually exist; (ii) the distribution of dividends on its own shares held by the company; (iii) distribution of dividends from statutory reserves. However, these are more fraud cases than accounting treatment, but sometimes the demarcation line between fraud and accounting treatment can be relatively thin. Another situation of unlawful distribution would be where dividends exceed the amount of paid payments, although Art. 67 paragraph (2) of the Companies Law provides for the proportionality of dividends in relation to the paid-up legal capital.

In addition to the four above listed cases, there are still three dividend situations, namely (i) the stock of optional reserves, (ii) those resulting from the revaluation, and (iii) capital related premiums issue, intake, merger and division). In other words, if these items of equity can be distributed as dividends. Among these, in this article we will deal with the capital-related premiums.

From the outset we must say that such a possibility is unclear in Law no. 31/1990 (the "Companies Law"), which states, at art. 67 paragraph (3), that dividends can be distributed only from "profits determined by law". Strictly from an accounting standpoint, the profit designated by law is *the positive result of the financial year, calculated as the difference between income and expense recognized in the income statement*. As we can see, the current form of the Companies Law uses the term "profit" rather than the "benefit" as before, through Law no. 441/2006 or the previous legislation (Article 183 C. com. [1]).

[1] Regarding art. 1902 of the Civil Code, the common use of both notions is an inadvertence may prevail before the Companies Law and the Accounting Law, as special laws.

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Replacement was probably due to the fact that the term "benefits" was not a defined one and, in the absence of a legal definition, different interpretations could be reached. Such a wide-ranging interpretation of the notion of benefit is that of profit plus any item of equity over the legal capital. According to art. 69 of the Companies Law, if there is a loss of the net asset, the legal capital will have to be reunited or reduced before any distribution or distribution can be made. *Per a contrario*, if there is no loss that would erode net assets below the amount of the legal capital, the company could distribute dividends from any net asset account that is added to the legal capital, including capital-related premiums.

If the provision of art. 67 paragraph (3) of the Companies Law shall be reported in the profit and loss account, that of art. 69 of the same law relates to the balance sheet, making the distribution acceptable. However, other legal provisions prohibit, directly or indirectly but unequivocally, the distribution of dividends from legal reserves and those resulting from the revaluation of assets, although they are added to the legal capital as a surplus.

According to art. 183 paragraph (3) of the Companies Law, "shall be included in the reserve fund, even if it has reached 20% of the share capital, the surplus obtained by selling the shares at a rate higher than their nominal value (i.e. the issue premiums, SB) if this surplus is not used to pay for issue or depreciation". On the one hand, by referring to the legal reserve regulated in paragraph (1) of Article 183, it is clear that by the "reserve fund" the legislator understands the legal reserve. And by including them in the legal reserve even if the 20% threshold has been reached, the legislator confers capital-related premiums on a different regime to that of profit, of which the levy for the legal reserve is not fully and at once, but gradually, limited to 5% per year.

Also, from the final thesis of art. 183 paragraph (3) it also follows that capital-linked premiums can only be used to "pay" the issue costs or write-offs that means the implicit cover of losses[2]. On the other hand, issuance premiums can be used to increase legal capital, as opposed to legal reserves (Article 210 paragraph (2) of the Companies Law). By increasing the legal capital, free bonds are distributed to the associates, which can then be sold and paid for, but which is not the equivalent of a dividend, although the procedure is called "payment of dividends in shares". Although it seems that shareholders get something from the company, similar to dividends, in reality the operation has no material impact. By distributing free shares, the value of the company is not reduced, such as the distribution of dividends, the only lowering value being that of shares, since at the same value the company increases the number of shares in circulation. So the shareholders will have more shares, but the value of each package will be the same as before, the only difference being that the package will be more, but cheaper, instead of fewer but more expensive.

The difference in the economic realm of dividends and free shares is fundamental because the distribution of dividends is a decapitalization of the company (at least from an accounting point of view, that is a reduction of its net assets), while retaining the profit is a retention its capitalization, and if profit is further

[2] Expenditure on the issue of shares, depreciation or any other type of expense (costs) is recorded in the income statement together with income. The positive result of this account, when revenues exceed expenditures, is called “profit”, and the negative, when spending exceeds revenue, is called “loss”. The positive or negative result is included in the balance sheet in account 117, that is, in the class of the capital accounts (class 1), together with the capital related premiums (account 104). As the losses erode the net assets, the issue premiums will be used to cover these losses within Class 1. This is the meaning of the issuance premiums referred to in Article 183 paragraph (3) of the Companies Law that means nothing new: issuance premiums, like any other equity, are used to cover losses.

used to increase the legal capital, it can never be distributed. The fact that free shares can be sold does not change the situation any more, as the shareholder sells for consideration something that has been received free of charge from a legal point of view; from an economic point of view, the situation is the same as if it had not received the free shares but would have alienated a (lower) share of the (more valuable) shares existing before the distribution of the equity items in the form of free shares.

Issuance premiums are also net asset items that, although not attributable to profit, are generated by a company's activity (and not by market fluctuations), in particular the issue of equity securities (in practice, shares) "in gain". The first capital-linked, therefore, goes into company with the contributions, which is why they have been called by the doctrine "a supplement to capital / contribution not embedded in capital" or "left at the disposal of the company". A company gets more than the par value for the mere fact that the value of a share is the ratio between the value of the company and the number of shares in circulation, and it is very possible that the value of a share is greater than the arbitrary par value.

The positive difference is the premium issue and, the bigger, the more valuable the company, the gain is part of the shareholders equity. This economic principle, coupled with a logical distribution of the surplus to the shareholders at the voluntary liquidation of the company, could be an argument in favor of the possibility of distributing dividends from the premiums.

Awaiting the liquidation of the company for the shareholders to be able to benefit from the distribution of the net asset of which the premiums are part does not seem an option for the going concern companies[3] established for an indefinite duration, which assume the activity as a going concern, and therefore, who have not proposed a voluntary liquidation. In the case of these companies (i.e. quasi-totality), liquidation is only the result of an unfortunate situation, bankruptcy, when shareholders get nothing[4]. On the other hand, if we did not have a par value (a value that is an arbitrary element), the issue premiums would not exist, but only a share issue price that would determine the subscribed capital. So, if it is not important how the issue price is composed (par value + premium), but that both together represent the subscription value, it follows that the legal regime of the premium is similar to the par value (i.e. the legal capital), so unsustainable distribution.

Given that not only the arguments are both pro and contra, the existence of contradictory provisions in the Company Law prevents us from unfortunately giving a clear legal answer to the issue of the distribution of dividends from the premiums. The EU Company Directive **2017/1132** does not help us to elucidate this issue, as it does not define the term "reserves" other than those created by profit-taking but refers to national regulations[5].

Given that the distribution of dividends "from fictitious profits or which could not be distributed, in the absence of a financial situation or contrary to those presented from them" exceeds the civil framework,

[3] Point 49 of the MoF Order no. 1802/2014 thus defines "the principle of going concern": this principle assumes that the entity normally continues its operation without going into liquidation or significant reduction of activity.

[4] Based on the Commercial Code, it has been argued that the issue premiums could be used to distribute dividends if the status permits.

[5] Article 56 paragraph (3): „*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 carried forward and sums drawn from reserves available for this purpose, less any losses carried forward and sums placed to reserve in accordance to the law and statutes*". Although the text speaks of the charter, national legislation does not allow us to interpret either that a statutory change would be allowed to make the first capital-related distributions.

being incriminated by art. 272¹ letter b) of the Company Law, as failure to comply with the provisions on the establishment of the "reserve fund" is also incriminated, according to art. 272 paragraph (1) letter d) from the same law, we have to conclude that it is wise, by a wide law, that capital-related premiums are not distributed until a legal, national or European clarification.

The company could use an alternative distribution solution to incorporate premiums into the legal capital by increasing, and distributing free shares which they would then redeem from their shareholders at their fair market value. But here, there are risks even though the operation is no longer incriminated, because art. 103¹ paragraph (1) letter (d) of the Companies Law is also unequivocal as regards the permission or prohibition of the use of capital-related premiums for the payment of its own shares. In any event, such a situation does not amount to the sale of the shares received free of charge to a third party, which is alleged earlier, since, when the acquisition is made *pro rata* from all shareholders, they retain, after sale, the same shareholding, while a sale to a third party of the shares received free of charge reduces the participation quota.

Also, a purchase of its own shares de-capitalizes the issuing company, just like the distribution of dividends (that is why operations are often economically equivalent, the only differences being in the tax domain), while the sale to third parties of the free shares has no impact on the company's capitalization. *De lege ferenda*, the redemption of free shares should be regulated in conjunction with the regulation of the distribution of capital-related dividends in the form of dividends, so that the legal treatment is unitary.

There is currently a discussion in the European Union about the possibility of using solvency tests to allow the distribution of dividends and other equity accounts such as premiums. In any case, *de lege ferenda*, our legislator itself should regulate much more closely and be more careful about the distribution of dividends, including in criminal matters. Equivocal notions or expressions inconsistent with accounting definitions either lead to self-censorship of behavior, with negative effects on shareholders, or expose directors and directors to significant risks.

Conclusion

Establishing distributable profit is not such a mild operation as it appears, so the legislator should intervene and regulate the situation of those equity items which, although not resulting from the company's commercial transactions as a legal person, are nevertheless a surplus of legal capital and legal reserves. In addition, the acquisition of own shares should be assimilated to that of dividends, or, in other words, the two operations should be settled on a unitary basis.

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