

Undercapitalization – Tougher sanctions to be expected

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In mid-October the Romanian senate approved a draft law¹ referring to undercapitalized companies. It includes clarifications, restrictions and new sanctions in cases of undercapitalization. Currently, it is being discussed in the Chamber of Deputies.

There are already provisions in this sense², however they are too broadly tackled. The draft law aims, among other things, to regulate this matter more specifically, to improve collection of budgetary receivables and (very important) to “clean up” undercapitalized companies in the medium term.

The definition and meaning of net assets

The assets of a company are asset components labelled in bookkeeping terms as “positive”. They include all elements that provide the company with liquidities, such as fixed assets, stocks, cash, receivables. On the other hand, liabilities are labelled as “negative” and represent the capital sources of the company consisting of paid-up capital and borrowed capital (debt). The total assets correspond, in amount, to the total liabilities.

The **net assets** are calculated as the difference between the assets and the debts of a company; their value is identical to that of the company’s equity capital. From an economic point of view, the net assets represent the value that the shareholders would receive in the case of a possible liquidation, after utilization of assets and payment of debts.

They are an important indicator for the financial position of a company: a growth tendency shows a good economic evolution; a drop below the value of the share capital shows, however, that the debts of the company exceed its resources.

If the management determines the drop of the net assets (company’s capital) below half of the share capital (undercapitalization), an extraordinary shareholders’ meeting must be called. They have to decide if the company will be liquidated or not. If no liquidation is decided upon, the company must take measures to increase its net assets until the end of the following year. Otherwise, every interested person can request juridically the liquidation of the company³.

New regulations

Worth mentioning are the following:

- The debts of companies originating from shareholders’ loans must be, under certain conditions, turned into shares.
- Companies that have opted for the quarterly distribution of dividends may not grant any advance payments or loans to the shareholders as long as the quarterly dividends are not ultimately determined and regulated.

¹https://www.senat.ro/legis/lista.aspx?nr_cls=L493&an_cls=2019

²Art. 153²⁴ of the companies law (Law 31/1990)

³ This has however hardly ever happened in practice

- The distribution of dividends is allowed only after the net assets are brought above the legal threshold.
- New registration obligations towards the financial administration: based on this, the Ministry of Finance is preparing to publish a list of undercapitalized companies. The undercapitalization is also registered with the Commercial Register.
- The Romanian Fiscal Administration is authorized, under certain conditions, to initiate the dissolution of undercapitalized companies.
- Rules and stages for building and distributing reserves, the result brought forward for the distribution of dividends, transfer regulations, and sanctions will be introduced.

Based on the regulations above, the following course of action – that will last for 3 years – must be followed.

1. The determination of the undercapitalization upon preparation of the financial year (for example for the year N)
2. Within 2 years: the convocation of a shareholders' meeting, the communication of their decisions to the financial administration, the supervision by the fiscal authorities and the Commercial Register, measures for increasing the company's capital (Years N+1, N+2):
3. In the following year (N+3):
 - At the beginning of the year: turning shareholder debts resulting from loans by the shareholders into shares, if the increase of the net assets has not succeeded;
 - After 60 days following the expiry of the submission deadline for the financial statements: the right of the fiscal administration to request the dissolution of the company if the undercapitalization persists.

Conclusion

According to the information provided by the Commercial Register, more than 270,000 companies (ca. 40%) are subject to undercapitalization. The need for the abovementioned measures was justified by the authorities by claiming that an undercapitalization could not be continued for a long time. In our opinion, the abovementioned regulations are likely to be adopted at least in a similar form as described above; however applied more stringently.

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