to the continuation of the fraud, but that is and remains its own loss. Secondly, S & R’s claim is for precisely the same loss as a company with some shareholders innocent of involvement in top management’s fraud would be entitled to claim from negligent auditors who had failed to detect and report the fraud (paras 249–255 above). Thirdly, it cannot be suggested that the care to be expected of Moore Stephens as auditors varied according to whether all of S & R’s shares happened to be owned and/or controlled by Mr Stojevic. Their express contractual duty was under auditing standard SAS 110.10 and 110.12 to report to a proper authority without delay where suspected or actual fraud cast doubt on the integrity of directors. This duty in fact exists under SAS 110 irrespective of whether there are or are not independent shareholders of integrity. Auditors would not in any event necessarily have any idea whether any such shareholders exist.

270 Fourthly, quite apart from the express provisions of auditing standard SAS 110, a situation of insolvency introduces new considerations for reasons previously explained. The identity of interest which normally exists between a company and its shareholders ceases, and the duties of auditors, like those of directors, must recognise this. The company as a legal personality continues and the auditors’ duty continues to be, in Lord Oliver’s words in *Caparo* (p 630), ‘to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing’. If, in Hobhouse J’s words in *Berg* [2002] Lloyd’s Rep PN 41, 55, ‘those in charge of the affairs of a company or in control of it are acting contrary to the principles governing insolvency’, then the auditors can no longer treat them as representing the company, and must take other action—according to SAS 110 ‘without informing the directors in advance’. …

(p. 481) ➣ Questions

1. In *Stone & Rolls*, Lord Walker said, ‘Much of the opinion of my noble and learned friend, Lord Mance, seems to me, with great respect, to be seeking to attenuate by indirect means the House’s decision in *Caparo*, although we are not invited to depart from it.’ Is this accurate?

2. What are the policy reasons in favour and against each of the opposing viewpoints advanced in the House of Lords?

3. Is it simply impossible in the context of a one man company to maintain purist adherence to the doctrine of separate legal personality? Or is the real problem a far more general one: we simply need special rules to deal with fraud and fraudsters?

Promoters and their dealings with the company

The term ‘promoter’ is not defined in the Companies Act, and such attempts at definition as have been made by the courts (mainly in the nineteenth century) seem to have been concerned only to ensure that enough flexibility was retained to catch the next ingenious rogue which the pre-incorporation period might produce. The best known of these is the description given by Cockburn CJ in *Twycross v Grant* (1877) 2 CPD 469 at 541: ‘one who undertakes to form a company with reference to a given project, and to set it going, and who takes the necessary steps to accomplish that purpose’.

There is an enormous body of old case law concerned with the obligations of promoters towards the companies which they form and the investing public whose capital they seek to attract. But to all intents and purposes this law has become obsolete. This is due partly to changes in the practice of marketing securities: it is unusual for a newly formed company to make an initial public issue, and not normally possible to obtain a market listing, without an established trading record. It is also due to the stringent control of such activities now imposed by statute and by the Listing Rules (which must be complied with in order to gain access to the Stock Exchange)[14] and the professional codes of issuing houses and others whose services are nowadays essential.

There is thus little need to include extracts from these cases, insofar as they relate to promoters' duties, as such cases are now mainly of historical interest.

CA 2006, too, pays little specific attention to promoters. The only issue of real concern is, perhaps predictably, the propriety of any sales of non-cash assets to the company by its promoters (or those in similar positions). Even here, CA 2006 only concerns itself with public companies. CA 2006 ss 598–604 require the independent valuation of all non-cash assets sold to a public company within two years of its formation or re-registration by persons who were either the subscribers to the memorandum at the time the company was registered as a public company, or were its members at the time it was re-classified and re-registered as a public company. The valuer's report must state that the asset is worth at least the price being paid for it by the company. In addition, the agreement for sale must be approved by an ordinary resolution of the company's members, and a copy of this resolution and the valuation sent to Companies House within 15 days of adoption. Companies House then gives public notice of receipt of the report (ss 1077 and 1078(3)). There are *de minimis* exceptions to these requirements if the asset is worth less than 10% of the nominal value of the company's allotted share capital. In addition, the rules do not apply to any sales in the normal course of the company's business.

(p. 482) Here the focus is simply on illustrations of the promoters' relationships and dealings with the company as a separate legal person. The next two cases have strong parallels with the approach taken to the relationship and dealings between a company and its directors.

Promoters are fiduciaries. A contract between the promoter and the company is voidable at the company's option unless the promoter has disclosed all material facts relating to that contract to an independent board, and the company has freely agreed to the terms.

[8.06] Erlanger v New Sombrero Phosphate Co (1878) 3 App Cas 1218 (House of Lords)

A syndicate headed by Erlanger, a Paris banker, acquired for £55,000 the lease of an island in the West Indies with the right to work its phosphate deposits. The syndicate, through Erlanger, then formed the respondent company and named its first directors. Of these, one, the Lord Mayor of London, was independent of the syndicate; two were abroad, and the remainder were mere puppets of Erlanger. The lease was then sold through a nominee to the company for £110,000, the purchase being 'ratified' without inquiry at a meeting of directors eight days after the incorporation of the company. Many members of the public subscribed for shares, but the real circumstances of the sale and purchase were not disclosed to them and were not discovered until eight months later, after the first phosphate shipments had proved a failure. The members then removed the original directors and elected a new board, which brought these proceedings to have the sale rescinded.

> LORD CAIRNS LC: In the whole of this proceeding … the syndicate, or the house of Erlanger as representing the syndicate, were the promoters of the company, and it is now necessary that I should state to your Lordships in what position I understand the promoters to be placed with reference to the company which they proposed to form. They stand, in my opinion, undoubtedly in a fiduciary position. They have in their hands the creation and moulding of the company; they have the power of defining how, and when, and in what shape, and under what supervision, it shall start into existence and begin to act as a trading corporation. If they are doing all this in order that the company may, as soon as it starts into life, become, through its managing directors, the purchaser of the property of themselves, the promoters, it is, in my opinion, incumbent upon the promoters to take care that in forming the company they provide it with an executive, that is to say, with a board of directors, who shall both be aware that the property which they are asked to buy is the property of the promoters, and who shall be competent and impartial judges as to whether the purchase ought or ought not to be made. I do not say that the owner of the property may not promote and form a joint stock company, and then sell his property to it, but I do say that if he does he is bound to take care that he sells it to the company through the medium of a board of directors who can and do exercise an independent and intelligent judgment on the transaction, and who are not left under the belief that the property belongs, not to the promoter, but to some other person …
>
> LORD O'HAGAN: The original purchase of the island of Sombrero was perfectly legitimate—and it was not less so because the object of the purchasers was to sell it again, and to sell it by forming a company

which might afford them a profit on the transaction. The law permitted them to take that course, and provided the machinery by which the transfer of their interest might be equitably and beneficially effected for themselves and those with whom they meant to deal. But the privilege given them for promoting such a company for such an object, involved obligations of a very serious kind. It required, in its exercise, the utmost good faith, the completest truthfulness, and a careful regard to the protection of the future shareholders. The power to nominate a directorate is manifestly capable of great abuse, and may involve, in the misuse of it, very evil consequences to multitudes of people who have little capacity to guard themselves. Such a power may or may not have been wisely permitted to exist. I venture to have doubts upon the point. It tempts too much to **(p. 483)** fraudulent contrivance and mischievous deception; and, at least, it should be watched with jealousy and restrained from employment in such a way as to mislead the ignorant and the unwary. In all such cases the directorate nominated by the promoters should stand between them and the public, with such independence and intelligence, that they may be expected to deal fairly, impartially and with adequate knowledge in the affairs submitted to their control. If they have not those qualities, they are unworthy of trust. They are the betrayers and not the guardians of the company they govern, and their acts should not receive the sanction of a court of justice.

Now, my Lords, for reasons repeatedly given by my noble and learned friends, which I shall not detail again, I think that the promoters in this case failed to remember the exigencies of their fiduciary position, when they appointed directors who were in no way independent of themselves, and who did not sustain the interests of the company with ordinary care and intelligence …

Apparently, there was no inquiry as to the enormous advance in the price …, no consideration of the state of the property—and no intelligent estimate of its capabilities and prospects. If the directors had been nominated merely to ratify any terms the promoters might dictate, they discharged their function; if it was their duty, as it certainly was, to protect the shareholders, they never seem to have thought of doing it. Their conduct was precisely that which might have been anticipated from the character of their selection, and taking that conduct and character together, I concur in, I believe, the unanimous opinion of your Lordships that such a transaction ought not to be allowed to stand.

The promoters, who so forgot their duty to the company they formed, as to give it a directorate without independence of position or vigilance and caution in caring for its interests, must take the consequences. And this without the necessary imputation of evil purpose or conscious fraud. The fiduciary obligation may be violated though there may be no intention to do injustice. If the protection, proper and needful for a person standing at disadvantage in relation to his guardian or his solicitor, or to the promoters of a company, be withheld, the guardian, the solicitor or the promoters cannot sustain a contract equitably invalidated by the want of it, merely because it may be impossible to prove that he is impeachable with indirect or improper motives …

LORDS PENZANCE, HATHERLEY, SELBORNE, BLACKBURN and GORDON delivered concurring opinions.

➢ Notes

1. The principles of fiduciary obligation are rules applied by the courts of equity to impose high standards of selfless conduct upon trustees and others, such as agents and solicitors, who undertake responsibility to look after the interests or handle the property of others. Company promoters and company directors (see Chapter 7) are subject to these rules.

2. It has been accepted at least since *Salomon v A Salomon & Co Ltd* **[2.01]** that, if there is no independent board of directors, the company may be bound by the consent of all the original *members*, provided that a full disclosure is made to them of all material facts. But, as is shown by *Gluckstein v Barnes* **[8.07]** even this will not protect a promoter if the original members themselves are not independent and the scheme as a whole is designed to attract and deceive the investing public at large.

Promoters, as fiduciaries, may not make a secret profit while acting in that capacity. Any profits so received must be accounted for to the company.

[8.07] Gluckstein v Barnes [1900] AC 240 (House of Lords)

Gluckstein and three others bought the Olympia exhibition premises in liquidation proceedings for £140,000 and then promoted a company, Olympia Ltd, to which they sold the property for £180,000. There were no independent directors. In a prospectus inviting applications for shares and debentures the £40,000 profit was disclosed, but not a further profit of some £20,000 **(p. 484)** which they had made by buying securities on the property at a discount and then enforcing them at their face value (though there was a vague reference to 'interim investments'). The company went into liquidation within four years, and the liquidator claimed in this action £6,341, part of the £20,000 received by Gluckstein.

> EARL OF HALSBURY LC: My Lords, I am wholly unable to understand any claim that these directors, vendors, syndicate, associates, have to retain this money. I entirely agree with the Master of the Rolls that the essence of this scheme was to form a company. It was essential that this should be done, and that they should be directors of it, who would purchase. The company should have been informed of what was being done and consulted whether they would have allowed this profit. I think the Master of the Rolls is absolutely right in saying that the duty to disclose is imposed by the plainest dictates of common honesty as well as by well-settled principles of common law.
>
> Of the facts there cannot be the least doubt; they are proved by the agreement, now that we know the subject-matter with which that agreement is intended to deal, although the agreement would not disclose what the nature of the transaction was to those who were not acquainted with the ingenious arrangements which were prepared for entrapping the intended victim of these arrangements.
>
> In order to protect themselves, as they supposed, they inserted in the prospectus, qualifying the statement that they had bought the property for £140,000, payable in cash, that they did not sell to the company, and did not intend to sell, any other profits made by the syndicate from interim investments.
>
> Then it is said there is the alternative suggested upon the agreement that the syndicate might sell to a company or to some other purchaser. In the first place, I do not believe they ever intended to sell to anybody else other than a company. An individual purchaser might ask inconvenient questions, and if they or any one of them had stated as an inducement to an individual purchaser that £140,000 was given for the property, when in fact £20,000 less had been given, it is a great error to suppose that the law is not strong enough to reach such a statement; but as I say, I do not believe it was ever intended to get an individual purchaser, even if such an intention would have had any operation. When they did afterwards sell to a company, they took very good care there should be no one who could ask questions. They were to be sellers to themselves as buyers, and it was a necessary provision to the plan that they were to be both sellers and buyers, and as buyers to get the money to pay for the purchase from the pockets of deluded shareholders.
>
> My Lords, I decline to discuss the question of disclosure to the company. It is too absurd to suggest that a disclosure to the parties to this transaction is a disclosure to the company of which these directors were the proper guardians and trustees. They were there by the terms of the agreement to do the work of the syndicate, that is to say, to cheat the shareholders; and this, forsooth, is to be treated as a disclosure to the company, when they were really there to hoodwink the shareholders, and so far from protecting them, were to obtain from them the money, the produce of their nefarious plans.
>
> I do not discuss either the sum sued for, or why Gluckstein alone is sued.
>
> The whole sum has been obtained by a very gross fraud, and all who were parties to it are responsible to make good what they have obtained and withheld from the shareholders.

I move your Lordships that the appeal be dismissed with costs.

LORD MACNAGHTEN: My Lords, Mr Swinfen Eady argued this appeal with his usual ability, but the case is far too clear for argument … For my part, I cannot see any ingenuity or any novelty in the trick which Mr Gluckstein and his associates practised on the persons whom they invited to take shares in Olympia Limited. It is the old story. It has been done over and over again.

These gentlemen set about forming a company to pay them a handsome sum for taking off their hands a property which they had contracted to buy with that end in view. They bring the company into existence by means of the usual machinery. They appoint themselves sole guardians and protectors of this creature of theirs, half-fledged and just struggling into life, bound hand and foot while **(p. 485)** yet unborn by contracts tending to their private advantage, and so fashioned by its makers that it could only act by their hands and only see through their eyes. They issue a prospectus representing that they had agreed to purchase the property for a sum largely in excess of the amount which they had, in fact, to pay. On the faith of this prospectus they collect subscriptions from a confiding and credulous public. And then comes the last act. Secretly, and therefore dishonestly, they put into their own pockets the difference between the real and the pretended price. After a brief career the company is ordered to be wound up. In the course of the liquidation the trick is discovered. Mr Gluckstein is called upon to make good a portion of the sum which he and his associates had mis-appropriated. Why Mr Gluckstein alone was selected for attack I do not know any more than I know why he was only asked to pay back a fraction of the money improperly withdrawn from the coffers of the company.

However that may be, Mr Gluckstein defends his conduct or, rather I should say, resists the demand, on four grounds, which have been gravely argued at the bar. In the first place, he says that he was not in a fiduciary position towards Olympia Limited, before the company was formed. Well, for some purposes he was not. For others he was. A good deal might be said on the point. But to my mind the point is immaterial, for it is not necessary to go back beyond the formation of the company.

In the second place, he says that if he was in a fiduciary position he did in fact make a proper disclosure. With all deference to the learned counsel for the appellant, that seems to me to be absurd. 'Disclosure' is not the most appropriate word to use when a person who plays many parts announces to himself in one character what he has done and is doing in another. To talk of disclosure to the thing called the company, when as yet there were no shareholders, is a mere farce. To the intended shareholders there was no disclosure at all. On them was practised an elaborate system of deception.

The third ground of defence was that the only remedy was rescission. That defence, in the circumstances of the present case, seems to me to be as contrary to common sense as it is to authority. The point was settled more than sixty years ago by the decision in *Hichens v Congreve*[15] and so far as I know, that case has never been questioned.

The last defence of all was that, however much the shareholders may have been wronged, they have bound themselves by a special bargain, sacred under the provisions of the Companies Act 1862,[[16]] to bear their wrongs in silence. In other words, Mr Gluckstein boldly asserts that he is entitled to use the provisions of an Act of Parliament, which are directed to a very different purpose, as a shield and shelter against the just consequences of his fraud …

There are two things in this case which puzzle me much, and I do not suppose that I shall ever understand them. I mention them merely because I should be very sorry if it were thought that in those two matters the House unanimously approved of what has been done. I do not understand why Mr Gluckstein and his associates were not called upon to refund the whole of the money which they misappropriated. What they did with it, whether they put it in their own pockets or distributed it among their confederates, or spent it in charity, seems to me absolutely immaterial. In the next place, I do not understand why Mr Gluckstein was only charged with interest at the rate of 3%. I should have thought it was a case for penal interest.

In these two matters Mr Gluckstein has been in my opinion extremely fortunate. But he complains that he may have a difficulty in recovering from his co-directors their share of the spoil, and he asks that the official

liquidator may proceed against his associates before calling upon him to make good the whole amount with which he has been charged. My Lords, there may be occasions in which that would be a proper course to take. But I cannot think that this is a case in which any indulgence ought to be shown to Mr Gluckstein. He may or may not be able to recover a contribution **(p. 486)** from those who joined with him in defrauding the company. He can bring an action at law if he likes. If he hesitates to take that course or takes it and fails, then his only remedy lies in an appeal to that sense of honour which is popularly supposed to exist among robbers of a humbler type. I agree that the appeal must be dismissed with costs.

LORD ROBERTSON delivered a concurring opinion.

See also *Re Darby* **[2.16]**.

➢ Notes

1. A wide choice of remedies is available against a promoter who has acted in breach of his fiduciary obligations. The company may rescind any contract between the promoter and the newly formed company (see *Erlanger* **[8.06]**, and the following Note 3), or the company may bring proceedings for the restitution of a benefit which the promoter has received from third parties, either in equity on the basis of a constructive trust (although note the debate at *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd (In Administration)* **[7.38]** and following, on proprietary remedies), or at law as a claim for money had and received. The parties to a secret bargain may also be sued in an action of deceit. Where a promoter has been promised, but has not received, a profit, bribe or other benefit, the company may itself enforce his claim for payment against the promisor, on the ground that he holds the claim as trustee for it: *Whaley Bridge Calico Printing Co v Green* (1879) 5 QBD 109.

2. Where the company does not seem able to available itself of the remedies noted earlier (most commonly because rescission is barred because *restitutio in integrum* has become impossible), then the courts have often avoided the ensuing injustice by finding the promoter liable in *damages* for deceit (see, eg, *Re Leeds and Hanley Theatres of Varieties Ltd* [1902] 2 Ch 809, CA), or for negligence in allowing the company to purchase at too high a price (see, eg, *Jacobus Marler Estates Ltd v Marler* (1913) 85 LJPC 167n, PC), or under the Misrepresentation Act 1967 (*if* there has been an actionable misrepresentation[17]).[18]

3. Where a promoter has sold to his company property which he did not acquire as a promoter or did not acquire with a view to launching the promotion—for example, property which he inherited some years before—the remedy of rescission of the contract of sale is, of course, available to the company if he did not make a proper disclosure of his interest at the time of the sale. However, if rescission is no longer possible (eg because of supervening third party rights), or if the company elects to affirm the contract, an alternative remedy by way of an account of profits does not lie: *Re Cape Breton Co* (1885) 29 Ch D 795, CA; *Ladywell Mining Co v Brookes* (1887) 35 Ch D 400, CA. This seemingly anomalous rule is commonly explained by saying that the promoter's alleged 'profit' is unquantifiable, and that by giving such a remedy the court would in effect be fixing a new price for the parties.

4. These old rulings on the liability of promoters are significant because there is a close parallel between the fiduciary obligations of promoters and the fiduciary obligations of directors (see Chapter 7), and decisions like *Re Cape Breton Co* may be relevant in the latter context. Compare the rules as they apply to directors, especially where there has been statutory intervention: **(p. 487)** see 'CA 2006 s 40: statutory deeming provisions to avoid constitutional limitations on directors' authority', p 97 (in the context of CA 2006 s 41), and 'Directors' duties are owed to the company', pp 319ff (in the context of directors' statutory duties).

5. A promoter may also be liable to pay compensation to persons who subscribe for shares or other securities on the faith of listing particulars or a prospectus for which he is responsible: see 'Liability for misleading statements and omissions in prospectuses', pp 727ff.

➢ Question

Suppose that the company on facts similar to *Re Cape Breton Co were* to bring an action for equitable compensation 19 against the promoter-vendor, and it is accepted that there is jurisdiction to award such compensation. What issues in regard to (i) causation and (ii) the measure of compensation would arise, and how do you think that they should be resolved?

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Notes:

[1] This nomenclature may be evocative, but perhaps it cannot survive Lord Hoffmann's analysis of the rules of attribution in *Meridian Global* **[3.29]**.

[2] Ie, on the grounds of divergence of opinions on accounting treatments or audit procedures, or on any other improper grounds (not specified).

[3] Although it seems the removal is effective in the meantime, subject to any court orders under s 996.

[4] It is not clear why the Directive requirement was implemented through an amendment to CA 2006 s 994 rather than an amendment to s 510 (removal of auditors by ordinary resolution), although the decision may avoid some of the difficulties that members typically have in enforcing their statutory and constitutional rights (see 'Members' personal rights', pp 249ff).

[5] For an up-to-date track of the process, see: www.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2011/0359%28COD%29; for the proposal itself:http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0779:FIN:EN:PDF.

[6] http://ec.europa.eu/internal_market/auditing/docs/reform/COM_2011_778_en.pdf.

[7] Note the legal and practical distinction between Directives and Regulations.

[8] www.frc.org.uk/getattachment/4794e206-50a7-45d1-815c-7393046fef33/Consultation-Dicument-revisions-toteh-UK-Corporat.aspx.

[9] 174 NE 441 at 444 (1931).

[10] *Candlewood Navigation Corpn Ltd v Mitsui OSK Lines Ltd* [1986] AC 1 at 25, PC.

[11] [1990] Ch 313.

[12] Although, by contrast, see *In Mira Makar v PricewaterhouseCoopers LLP* [2011] EWHC 3835 (Comm), where the court *was* prepared to strike down an application made by the claimant, who was the chief executive director and former director of a company which engaged PricewaterhouseCoopers as its auditor. In the absence of matters pleaded suggesting 'exceptional circumstances of a special relation or any intention on the part of the auditors that a director such as the claimant should rely on the audit' [28]–[29], Teare J found that there was no arguable case for alleging that a duty of care was owed by the auditors to the claimant as the director of the company being audited.

[13] See **[3.32]** for the details of this debate.

[14] See Chapter 14.

[15] (1831) 4 Sim 420.

[16] Lord Macnaghten is referring to the fact that the contract to purchase the premises was expressly mentioned in the company's memorandum and articles; the 'bargain' was the 'statutory contract' created by the equivalent of CA 2006 s 33 ('Members' personal rights', p 250).

[17] Mere non-disclosure of profit is not such a misrepresentation: see *Jacobus Marler Estates Ltd* in *Cook v Deeks* **[7.22]**.

[18] These damages or equitable compensation remedies are *not* awarded for breach of the promoter's *fiduciary* obligation, but for breach of other legal or equitable obligations owed (by the fiduciary promoter) to the company. See *Target Holdings Ltd v Redferns* [1996] AC 421, HL and *Knight v Frost* [1999] 1 BCLC 364 at 373. But also see, IE Davidson, 'The Equitable Remedy of Compensation?' (1982) 13 *Melbourne University Law Review* 349 and WMC Gummow, 'Compensation for Breach of Fiduciary Duty' in TG Youdan (ed), *Equity Fiduciaries and Trusts* (1989), ch 2, arguing that compensation (not, strictly speaking, damages) was commonly awarded in an earlier period for at least some breaches of fiduciary obligation.

9. The Raising of Capital

Chapter: **(p. 488)** 9. The Raising of Capital
Author(s): Len Sealy and Sarah Worthington
DOI: 10.1093/he/9780199676446.003.0009

Company 'capital' and its importance

'Capital' is a word that can have many meanings. In company law, however, *legal capital* (or simply '*capital*') may be used in a restricted technical sense. Broadly speaking, it is cash (or, less often, the value of the assets) received by the company from investors who subscribe for the company's shares.[1] The company's capital, in this technical sense, is measured in terms of 'value received' into the company, rather than the current value of the assets themselves, since that will change with the business activities of the company. If the company receives cash in exchange for its shares, for example, the company will use that cash to promote and expand the company's business. If the business is successful, the value of the business will increase; if not, it will decrease.

The value of the company's legal capital is likely to be far less than the total value of the company's assets. Even before the company begins to trade, and certainly once it is up and running, the company is likely to borrow money from banks and from other lending sources. It is also likely to rely on other sources of credit, such as debt funding from suppliers who supply the company with goods and services on deferred payment terms or 'on credit'. None of this large and small scale '*debt funding*' is part of the company's legal capital. Important distinctions exist between the treatment of debt, and the *creditors* who provide those funds,[2] and the treatment of '*equity funding*' (as fundraising by share issues is known) and the *shareholders* who provide those funds. Both sources of funds will be deployed in the company's business, however, and, if the business is successful, will generate additional company assets by way of retained business profits. These profits do not form part of the company's legal capital either. Of course, if the business is unsuccessful and losses are incurred, the total value of the company's assets, and hence its *capital*, may fall below the company's legal capital.

Why is such a sharp distinction drawn between legal capital (or contributions from shareholders) and other assets held by the company? The distinction reflects the special protection provided to creditors by the company's legal capital. This is seen most dramatically when the company is in financial difficulty. Take a simple example. Suppose a company is set up with £100,000 in 'equity funding' contributed by shareholders, and £200,000 in 'debt funding' provided over time by the bank and other creditors. If the business fails, and the company is put into insolvency, then whatever remains of the company's assets will be used to repay the company's creditors, in full if possible, before any of the shareholders are repaid any part of their contribution to funding the company. In other words, the two types of financiers of the company's operation do not share the losses equally. In the example given, suppose the company's remaining assets amount to £150,000. The creditors clearly cannot be repaid in **(p. 489)** full, but they will share *all* of this sum (obtaining 75p in the pound), and the shareholders will receive nothing. Of course, in practice the situation is usually more complicated. There are invariably different types of creditors (some with security provided by mortgages and charges, others unsecured, and still others given special privileges and priorities by statute), and there may be different classes of shareholders (perhaps with different rights when the company goes into insolvency). And some part of the company's assets will need to be spent simply in the mechanics of sale and distribution to those entitled (the expenses of liquidation and receivership). All of this detail is covered later.[3]

The outlook for the shareholder is not all gloomy, of course. If the company is successful, then the shareholders, not the creditors, will share in the company's profits. The shareholders will receive dividends (distributions based on company profits),[4] and the value of their shares is likely to increase by the value of retained profits and enhanced expectations about future profits (so that if they sell their investment to a third party, they will reap a capital gain). The creditors, on the other hand, are restricted to the scale of return defined by their contract with the company (eg a loan with specified rate of interest, or a sale of goods with a built-in profit margin).

Finally, by way of concluding introductory comment, note that contributions to a company's capital are made only by shareholders purchasing shares *from the company*. When these shareholders then sell their shares to third parties (who will become the new shareholders), they may sell at a price far greater, or far less, than the price initially paid to the company for the share. But this sale price is received *by the shareholders*, and, although it will reflect their personal profit or loss on the investment, it will not alter the company's legal capital.

Many shareholders are motivated by the possibility of realising an increase in total shareholder value comprising capital gain on their share investment and dividends (ie income from the investment), rather than by the attraction of being an 'owner' of a small business (ie by the benefits of management or voting control). Markets, such as the London Stock Exchange, were originally set up and regulated precisely to provide for this possibility. Their importance in attracting investors is well recognised by the increasing efforts put into appropriate regulation.[5]

Attracting and protecting shareholders and creditors

The interplay between the rights of shareholders and the rights of creditors is critical to the success of companies as business entities. A company is a separate legal person. It follows that the claims of the company's creditors must be met from the company's assets.[6] The shareholders' capital contributions mitigate the risks to which creditors are exposed. The returns for shareholders are proportionately greater if the company is a success, and proportionately worse if the company is a failure. That is why the cost of equity funding (in terms of *expected* total shareholder return) is generally higher than for debt funding (an *expected* interest entitlement). In addition, if shareholders are to be attracted to this form of investment, then there must be appropriate protections of their rights and appropriate limitations on their obligations. And, unless shareholders are attracted, creditors are unlikely to be forthcoming.

(p. 490) For shareholders, these protections include:

(i) limitations on the issue of new shares, so that shareholders' interests in the company are not unacceptably diluted (*pre-emption rights* and *limitations on the directors' powers of allotment*) (see 'Limiting access to shares: directors' allotment rights and shareholders' pre-emption rights', pp 496ff);
(ii) protection against misleading inducements to purchase shares (see 'Offers to the public to purchase shares and remedies for misleading offers', pp 499ff);
(iii) protection of the financial rights attached to shares (including protection of 'class rights') (see Chapter 11);
(iv) protection of shareholders' established and agreed relationships with the company (via shareholder control over changes to the company's constitution (see Chapter 2), or by personal claims by shareholders against the company or its managers, as permitted by common law (under Companies Act 2006 (CA 2006) s 33) or by statute (eg CA 2006 s 994) (see Chapter 13));
(v) protection of shareholders' influence over the potential success of the company (via control over the management, and, sometimes, control over the pursuit of claims on behalf of the company) (see Chapters 4, 6 and 13).

Only the first two of these are directly associated with the process of raising capital for the company, and are dealt with in this chapter.

What of the protection provided for company lenders and other creditors? Normal rules of contract law and security law (see Chapters 13 and 16) provide much assistance. Here, however, we are concerned with the special protections associated with the acquisition and treatment of company capital. These protective rules include:

(i) rules requiring the company to have a certain minimum level of capital before it begins trading ('*minimum capital requirements*') (see 'Minimum capital requirements for company formation', p 495);
(ii) rules designed to ensure that the amount of legal capital shown in the company records is in fact received in full by the company (rules relating to *payment for shares*) (see 'Collecting in the company's capital: payment for shares', p 504);
(iii) rules designed to ensure the maintenance of stated levels of legal capital by restricting the freedom of companies to return assets to its shareholders ('*capital maintenance rules*' and '*dividend distribution rules*')

(see Chapter 10).

Terminology associated with legal capital

Various terms are commonly used, and need to be understood. These include ‘allotment’ and ‘issue’ of shares, and ‘authorised’ or ‘nominal’ capital (the terms are interchangeable, and are of less concern now that CA 2006 has abolished the requirement to state this value, although of course it appears in older cases), ‘nominal value’ or ‘par value’ (again used interchangeably), ‘issued capital’ and ‘share premiums’.

Formally a share is not *issued* to a shareholder until the investor’s name is registered in the company’s register of members (CA 2006 s 113). This is when the shareholder acquires the legal title to the share. Until this has been done the person entitled to the shares is neither a member nor their legal owner. Of course, there is an earlier stage, where the company enters into a binding contract with the investor to sell a share in return for payment of the price, and the investor acquires an unconditional right to be included in the company’s register of members in respect of the shares; a share is then said to be *allotted* to the investor (CA 2006 s 558).

(p. 491) All companies with shares used to be incorporated with a ‘*nominal*’ or ‘*authorised*’ *capital*, the total amount of which had to be stated in the memorandum (ie the document which, with the articles, provided the company’s constitution). This figure had very little practical significance. It merely fixed a ceiling upon the amount of capital the company could raise by the issue of shares without further formalities. For example, a company might be incorporated with an authorised capital of £1 million, indicating that it was entitled to sell £1 million worth of shares to shareholders; in fact it might only issue £500,000 worth of shares, or even only £100,000 worth of shares.[7] Indeed, companies typically plucked large figures out of the air for authorised capital, since the only significance was to set this notional cap on issues, a cap which could in any event be increased by ordinary resolution of the shareholders.

The specified authorised capital was required to be divided into shares of a fixed unit value. In other words, a monetary value had (and still has: CA 2006 s 542[8]) to be attached to the shares. As a consequence, it is common to describe a company’s capital as divided into a certain number of ‘£1’ shares, or ‘10p’ shares. We would then say that the ‘*nominal value*’ or ‘*par value*’ of the shares was £1 or 10p respectively.

When the company *allots* or, later on, *issues* some of these shares, it is possible to speak of ‘allotted’ or ‘issued’ capital (CA 2006 s 546). The ‘*issued capital*’ (or, in the case of the first shareholders, the ‘*subscribed capital*’) is the sum equivalent to the nominal value or par value of all the shares that have been issued, and the ‘*paid-up capital*’ is so much of the issued capital as is represented by money which the shareholders have in fact paid: there may be an unpaid balance on each share which is not due for payment until a call is made (although this is rarely the case now; shares are usually issued fully paid, so the issued capital and paid-up capital are identical). CA 2006 s 547 also defines ‘called-up share capital’, which is the aggregate of paid-up capital plus capital that has been called up (whether or not paid) plus any defined commitments to pay share capital at a future date, but which has not yet been called up or paid.

So, in *Salomon*’s case **[2.01]**, the authorised or nominal capital was £40,000 comprising 40,000 shares of £1 each; the subscribed capital was £7, the total issued capital was £20,007, which was fully paid up, and the debt capital (a loan secured by the debenture) was a further £10,000.

Note that the ‘issued capital’ is *not* simply the consideration received by the company for the sale of its shares. The calculation is more convoluted. The advantage of this, if there is one, is that it enables a creditor to calculate that if a company has issued 100,000 shares with a nominal value of £1, for example, then the company’s issued capital is £100,000, and this sum is subject to all the capital maintenance and other creditor protection rules supplied by company law. In other words, the creditor has an easy basis on which to assess the company’s legal capital.

In fact, this easy calculation underestimates the extent to which a creditor is protected. It is perhaps obvious, given the way the nominal value is determined, that it bears no necessary relationship to the price at which the shares may be sold. When the company issues shares, it may well sell its ‘£1’ shares at a *premium* of £0.50 to the nominal value, that is, for £1.50, if that is what the market will bear.[9] The ‘legal capital’ rules insist that the