(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 company cannot sell its shares for *less* than the nominal value (see 'Collecting in the company's capital: payment for shares', p 504). But if it sells its shares for *more* than the nominal value, as in this **(p. 492)** case, then the £1 (representing the nominal value) received by the company must be allocated to the company's '*capital account*', and the £0.50 'premium' to the '*share premium account*'. The creditor is then super-protected, because the restrictions on the use of both accounts are reasonably similar, although not identical (see 'Issue of shares at a premium', p 506); in other words, the company does not receive a 'premium' which it is free to use at will, and the creditor receives buffering protection beyond the company's strict legal capital.[10]

CA 2006 specifies the acceptable uses of the share premium account: in line with the recommendations of the Company Law Review (CLR), the section imposes restrictions on the application of the share premium account that go beyond the Companies Act 1985 (CA 1985) rules. Companies are no longer able to use the account to write off preliminary expenses (ie expenses incurred in connection with the company's formation). Apart from two 'exceptions', and two forms of 'relief', the account can only be used as if it was a share capital account. The two exceptions are that the account may be used to write off any expenses incurred, or commission paid, in connection with the particular issue of shares, and also to pay up new shares to be allotted to existing members as fully paid bonus shares (CA 2006 s 610). The two forms of relief are related to mergers and reconstructions, and ensure that undistributed profits are not reallocated to share premium accounts, thus making them undistributable (CA 2006 ss 611 and 612).

As noted earlier, a company no longer needs to register its authorised capital when it is incorporated. Instead, the company must provide the registrar with a statement of capital and initial shareholdings. This statement must contain the following information:

(i) the total number of shares of the company to be taken on formation by the subscribers to the memorandum;
(ii) the aggregate nominal value of those shares;
(iii) for each class of shares: prescribed particulars of the rights attached to those shares, the total number of shares of that class and the aggregate nominal value of shares of that class; and
(iv) the amount to be paid up and the amount (if any) to be unpaid on each share (whether on account of the nominal value of the shares or by way of premium).

One historical point is worth making. It was very common practice in the early days for companies to issue shares on terms that only a small part of the capital—perhaps only 5% or 10% of the nominal value—was to be paid up, and so a very large sum of uncalled capital was left in reserve as a kind of 'guarantee fund' for creditors. Such shares were called *partly paid shares*; and the balance of unpaid capital could generally be *called up* by the company (or its liquidators) upon demand. This could have horrendous consequences for investors in the event of a liquidation (or, worse still, a spate of liquidations, as might occur in a recession) when the shareholder was obliged to pay up the balance of unpaid capital when there was no possibility of recovering any value via increased share value or future dividend. It also coloured much of the thinking in company law matters generally. Nowadays, the whole of the issue price of shares is normally payable on or soon after allotment, and so partly paid shares are not at all common. In some jurisdictions, they have been banned altogether, primarily for the sake of simplifying the law, but perhaps also out of a desire that investors should not be overcommitted with potential liabilities.

(p. 493) ➢ Questions

1. When shares in British Telecom plc were sold to the public in 1984, the company was permitted to issue a simplified prospectus, for the benefit of the 'wider' public. This prospectus omitted to state that the nominal value of the shares was 25p. Why might it have been thought appropriate to withhold this information?

2. The issue price of a 25p British Telecom share was £1.30. Were the shares expensive at that price?

3. If a dividend of 10p is paid on a share of nominal value 25p, does this mean that the investor has done well?

4. What protection is provided to creditors by having shares with a nominal value, and capital and share premium accounts, that could not be equally well provided by eliminating the concept of nominal value and

simply having a capital account for all the consideration received by a company for issue of its shares? (See DTI, *Completing the Structure* (URN 00/1335, November 2000) para 7.3; also see 'Issue of shares at a discount', p 504, on the inability of companies to issue shares at a discount.)

5. Are the exceptions and reliefs that apply in relation to use of the share premium account in accord with a philosophy that is actually designed to treat in the same way all the consideration received by a company for issue of its shares?

The legal nature of shares

Before investigating the detailed rules relating to legal capital, it is worth giving some attention to the legal nature of a share: what does a shareholder receive in return for providing the company with legal capital?

A share in a partnership reflects the partner's proprietary interest in the partnership assets: the assets are jointly owned by the partners. In the case of a company, it is not the shareholders but the company that owns the corporate assets, and the concept of a share serves somewhat different functions. In the first place, it is a fraction of the capital, denoting the holder's proportionate *financial stake* in the company and defining his or her liability to contribute to its equity funding. Secondly, it is a measure of the holder's interest in the company as *an association of members or shareholders* and the basis of his or her right to become a member and to enjoy the rights of voting, etc, so conferred. And, thirdly, it is a *species of property*, in its own right, a rather complex form of chose in action, which the holder can buy, sell, charge, etc, and in which there can be both legal and beneficial interests.[11] None of this is quite revealed in the definition in CA 2006 s 540.

The terms '*shareholder*' and '*member*' are commonly regarded as interchangeable, but this is not always the case. A company limited by guarantee has members, but it cannot have shareholders, for it has no shares. On the other hand, the holders of bearer shares ('share warrants', CA 2006 s 779—in practice these are rare) do not become members, since entry in the register of members is necessary for this purpose (s 112). The most common form of company is a company limited by shares, however, and in these companies the members are the shareholders.

(p. 494) Finally, a company can issue classes of shares with different rights attaching to each class (ie shares with different '*class rights*', see Chapter 11). For example, shares may have different voting rights (recall the weighted voting rights in *Bushell v Faith* **[6.02]**), different rights to dividends or different rights to capital on a return of capital or on winding up (all these rights are explained in Chapters 10 and 11). '*Preference shares*' have a preferred right (as defined in the articles or in the share issue itself) to a specified dividend (if any dividend is declared), and perhaps to a return of capital while the company is operating or on winding up. '*Ordinary shares*' are defined in CA 2006 s 560 as shares *other than* shares that carry a right to participate only up to a specified amount in a distribution of dividends or capital (ie other than preference shares). And '*equity securities*', also defined in CA 2006 s 560, are ordinary shares *and* rights to subscribe for, or convert securities into, ordinary shares. These definitions are important later, because certain rights, such as pre-emption rights, are given only to equity securities (see 'Limiting access to shares: directors' allotment rights and shareholders' pre-emption rights', pp 496ff).

What is a share?

[9.01] Borland's Trustee v Steel Bros & Co Ltd [1901] 1 Ch 279 (Chancery Division)

The company's articles provided that the shares of a member should in certain events, including bankruptcy, be transferable compulsorily to designated persons at a fair price not exceeding the par value.[12] On the bankruptcy of Borland, who held 73 £100 shares, the company gave notice to his trustee in bankruptcy requiring him to transfer the shares in accordance with the articles. The trustee objected that this provision in the articles was void, either on the ground that it was repugnant to absolute ownership, or as tending to perpetuity. The court rejected both contentions.

FARWELL J: It is said, first of all, that such provisions are repugnant to absolute ownership. It is said,

> further, that they tend to perpetuity. They are likened to the case of a settlor or testator who settles or gives a sum of money subject to executory limitations which are to arise in the future, interpreting the articles as if they provided that if at any time hereafter, during centuries to come, the company should desire the shares of a particular person … he must sell them. To my mind that is applying to the company law a principle which is wholly inapplicable thereto. It is the first time that any such suggestion has been made, and it rests, I think, on a misconception of what a share in a company really is. A share, according to the plaintiff's argument, is a sum of money which is dealt with in a particular manner by what are called for the purpose of argument executory limitations. To my mind it is nothing of the sort. A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s 16 of the Companies Act 1862 [CA 2006 s 33]. The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money settled in the way suggested, but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount … [His Lordship then held that the rule against perpetuities had no application to personal contracts such as this, and ruled that the article was valid and enforceable.]

(p. 495) ➤ Note

On the nature of the 'various rights' enjoyed by a shareholder, also see the description of Campbell J in the New South Wales Supreme Court in *White v Shortall* [2006] NSWSC 1379 at [197]–[199]:

> Some of the rights to sue the company that a shareholder has exist simply by virtue of having the status of shareholder, regardless of the number of shares held. Such rights include rights to receive the information that statute requires shareholders to be given, the right to be given notice of and to attend at certain meetings of the company, and the right to vote at certain company meetings. Other rights that a shareholder has to sue the company are ones that a shareholder has proportionately to the number of shares held—such as the right to a dividend, to a return of capital, or to vote on a poll at the meeting. Some of the rights of a shareholder to sue the company arise by virtue of the contract contained in the company's constitution. Other rights of a shareholder to sue the company—including some very important ones—might arise directly by statute (eg rights to receive accounts and reports, to join in a requisition of a company general meeting, or to appoint a proxy). Other rights that any shareholder has in a company by virtue of the status of being a shareholder can arise from a contract arising separately to the company's constitution (eg if the company in question holds itself out as willing to provide goods or services to a shareholder at a special discounted price).
>
> Some of the rights that attach to shares are themselves inherently assignable, even in circumstances where the shares themselves are not assigned—it is possible to make an equitable assignment of the right to receive dividends from a particular parcel of shares in particular years … and possible to make an equitable assignment of the right to receive some particular measure of money on a particular type of return of capital. Such assignments can take place only because the rights assigned are themselves treated as property. And the only type of property they could be is choses in action. Thus, some of the rights that a shareholder has by virtue of being a shareholder are themselves items of property that are separate to the item of property that constitutes the share itself.
>
> And it is not only fractional rights in a share that are capable of being seen as separate items of property. For rights of the type where the number of shares provides the measure by reference to which a shareholder's right against the company is calculated, the chose in action can be seen as being the right to sue the company to receive some particular type of benefit. For example, when the holder of 1000 shares in a company sues to recover a dividend that has been declared but is unpaid, there is just one action that the shareholder brings, to recover the dividend—there are not 1000 separate rights to be paid a dividend … In

that way, the chose in action—the thing that the law regards as a piece of property because it can be sued for—is the single right to be paid the dividend, the measure of which is the number of shares held.

> ➢ Question
>
> Do the compulsory share redemption provisions in *Borland's Trustee* offend the anti-deprivation principle? Would your answer be different if the terms provided for the sale of the deceased's shares at a *discounted* value? See Chapter 16.

Minimum capital requirements for company formation

A *public company* must have a nominal value of allotted share capital which is not less than the statutory 'authorised minimum' amount fixed by CA 2006 s 761. At present, the prescribed authorised minimum is £50,000, or the prescribed euro equivalent (s 763), denominated in sterling or euros, but not both (s 765). At least a quarter of this must be paid up before it begins trading (s 586).

(p. 496) The protection that this minimum delivers to creditors is dubious: the sum is relatively trivial, and is measured at the time the company commences trading, paying little account to what business risks or mishaps may happen as business continues. CA 2006 s 656 requires directors of public companies to call a general meeting to consider what to do if the company's assets fall to half or less than its called-up share capital. The equivalent CA 1985 predecessor to this seemed unimportant in practice: well before that stage some sort of rescue or insolvency procedure was likely to be in place (see Chapter 16).

There is no minimum capital requirement for *private* companies.

Limiting access to shares: directors' allotment rights and shareholders' pre-emption rights

Allotment

There is a risk that directors may use their power of allotment of shares to influence the composition of the company's membership, and in particular to ensure that the majority of members support them and will keep them in office (see 'Duty to act within powers: CA 2006 s 171', pp 331ff on directors' use of power for improper purposes).

CA 2006 ss 549–551 limit this possibility of abuse by providing as a general rule that it is an offence for directors to allot shares (or grant options to subscribe for shares or issue securities convertible into shares) without the authority of the members given either in the articles or by ordinary resolution. This authority must be renewed every five years.[13]

The exceptions relate to: (i) issues of shares to the original subscribers, to an employees' share scheme or to existing holders of rights to acquire or convert their shares (s 549); and (ii) in the case of a private company, issues of shares where the company has only one class of share (s 550), although such a company may restrict its directors' allotment powers by inserting a provision to that effect in the company's articles (s 550(b)).

Since there is now no 'authorised capital' limit, a company's changes to issued capital must be notified to the registrar at Companies House each time a new allotment is made (s 555).

Pre-emption rights governing the issue of new shares

A *pre-emption right* is a right of first refusal given to the shareholders of a company to subscribe for any new shares that the company issues in proportion to their existing shareholdings. In this way, the balance of control between the respective shareholders can be maintained. A pre-emption right may also prevent the ‘watering’ or dilution in value of existing shares, which will happen if the new shares are issued at a price which is below their true value.

Prior to 1980, shareholders were legally entitled to pre-emption rights only if this was expressly provided for in the company’s articles; although it was a requirement under the London Stock Exchange’s Listing Rules that equity shares of listed companies should be offered in the first instance on a pro rata basis to existing equity shareholders. Since 1980, UK legislation implementing the Second EU Directive (and extending its provisions to private companies), has provided a statutory pre-emption right. The relevant provisions are in CA 2006 ss 560–577. The statutory right is given to ordinary shareholders (excluding the company itself as holder of treasury shares), and applies only to new issues of ‘equity securities’ (s 560).[14]

(p. 497) The right is subject to certain *exceptions* (issues of bonus shares or shares as part of an employee share scheme, and issues for non-cash consideration);*exclusions* (by the articles of private companies); *disapplications* (by the articles for private companies with only one class of shares, or generally by special resolution, or by statute for the sale of treasury shares); and *savings* (for other rules and for certain older pre-emption procedures) (see ss 564–577). The wide ambit of these exceptions means that in practice the statutory provisions do not impose a serious restriction on companies that wish not to be bound by them.

Breach of these provisions does not invalidate the new issue, but generally exposes the company and every officer who knowingly authorised or permitted the contravention to compensation claims in favour of those to whom offers should have been made (CA 2006 s 653).

Pre-emption rights governing the transfer of existing shares

Just as shareholders maintain control over power distributions in a company through pre-emption provisions applying to the issue of new shares, so they also do with transfers of existing shareholdings. Such pre-emption provisions are typically found in the articles or in a shareholder agreement (see ‘Constitutional documents: articles of association and the company’s objects’, and p 25, ‘Shareholders’ agreements’, p 244 for the advantages and disadvantages of these two options). Such restrictions are only possible in private companies, however; shares listed on stock exchanges must be freely transferable.

A pre-emption provision governing the transfer of issued shares was not triggered by a change in ownership of the corporate shareholder of those issued shares.

[9.02] Re Coroin Ltd [2011] EWHC 3466 (Chancery Division)

Coroin Ltd was formed for the purpose of acquiring control of four well-known hotels in London. The original investors were McKillen, the claimant (36.23%), Misland (a company owned by A&A Investments Ltd, itself owned by Peter Green and his family) (24.78%), Quinlan (35.4%) and McLaughlin (3.58%). Their interests were governed by a shareholder agreement which granted pre-emption rights in favour of existing shareholders should any one of the investors wish to sell its interest.

The Barclay brothers (Sir David and Sir Federick) wished to acquire complete ownership and control of Coroin. They acquired the interests of Quinlan and McLaughlin, but could not reach agreement with Mr McKillen. They did, however, purchase (via a corporate alter ego) the issued shares in Misland from A&A Investments. McKillen held that this acquisition of Misland breached the pre-emption provisions in the shareholder agreement. The court disagreed, holding that a proper construction of the shareholder agreement indicated that the sale of the shares in a corporate shareholder of the company did not trigger the pre-emption provisions.

> DAVID RICHARDS J: A principle applicable to pre-emption articles which has been repeated in the authorities is that, as the right to deal freely with a share is an important attribute of ownership and the prima facie right of a shareholder, the existence and extent of any restriction on transfer, such as pre-emption provisions, must be clearly stated: see in re *Smith and Fawcett Ltd* **[11.10]** at 306, *Greenhalgh v Mallard* [1943] 2 All ER 234 at 237 … In the case of [a shareholder] agreement, the court’s function is to

discern objectively the meaning of the provision against the relevant background facts. This fundamental principle applies as much to an ambiguously framed pre-emption provision as it does to any other. If, applying that approach, the court considers that, on the proper construction of the agreement, the right of pre-emption has arisen, the court should not reject it because there is a lack of clarity in the language used.

It is, however, right to say that pre-emption provisions are generally drafted with precision, as befits provisions dealing with property rights. As appears from authorities to which I later refer, **(p. 498)** commonly used phrases have distinct legal meanings and superficially small variations can have significant legal effects. This is a relevant consideration when construing pre-emption provisions, particularly when as in this case they are complex and have been professionally drafted, using and adapting well-known standard provisions.

…

Clause 6.1 identifies as the person who may give a transfer notice 'a Shareholder desiring to transfer one or more Shares (or any interest therein)'. Each word of significance in that phrase carries a legal meaning.

First, 'Shareholder' is defined in clause 1.1 as 'any holder of Shares for the time being and shall as the context permits include any beneficial owner of shares for the time being.' A 'holder' of shares is the person registered in the company's register of members as the holder of the shares. He holds the legal title to the shares. He may or may not own the beneficial interest in the shares, as the second part of the definition recognises. If company A owns the beneficial interest in shares registered in its name, it alone is the beneficial owner of the shares. This remains the case even though company A is wholly-owned by company B or by one individual, in accordance with basic principles of legal personality: *Salomon v A. Salomon & Co Ltd* **[2.01]**, *JH Rayner (Mincing Lane) Ltd v Department of Trade and Industry* [1990] 2 AC 418.

Secondly, what constitutes a 'desire', or an intention, to transfer shares has been considered in a number of authorities: *Lyle & Scott v. Scott's Trustees* [1959] AC 763, *Safeguard Industrial Investments Ltd v. National Westminster Bank Ltd* [1982] 1 WLR 589, *Theakston v. London Trust plc* [1984] BCLC 389.

Thirdly, a 'transfer' of shares means the transfer of the legal title to the shares, by providing a signed stock transfer form or other similar instrument and by registration of the transfer in the register of members: see *Lyle & Scott Ltd v. Scott's Trustees* (supra), *Safeguard Industrial Investments Ltd v. National Westminster Bank Ltd*(supra), *Scotto v. Petch, Re Sedgefield Steeplechase Co* (1927) Ltd [2001] BCC 889 (CA).

Fourthly, 'any interest therein' means a proprietary, i.e. beneficial, interest in the shares, as opposed to the legal title. These words are included so as to broaden the effect of clause 6.1, which without them would be confined to the legal title. It is nonetheless the language of property, and a precise use of it.

There can, in my judgment, be no dispute that, read on its own, clause 6.1 has no application to the case where company A is the legal and beneficial owner of shares in the company and the issued shares of company A are sold. Such a sale involves no change in company A's legal and beneficial ownership of the underlying shares, nor evidences a desire to transfer those shares or any interest in them.

No doubt for this reason, Mr Miles' submissions do not start with clause 6.1, but with clause 6.17:

> 'No Share nor any interest therein shall be transferred, sold or otherwise disposed of save as provided in this clause 6.'

He submits that the words 'any interest therein' are, as a matter of language, ambiguous. They may carry their legally accurate meaning of a proprietary interest or they may carry, as Mr Miles submits they do, a broader, commercial meaning which would include the sale of a company owning the shares. [… and, after considering the issues …]

These unambiguous provisions [6.6, 6.1 and 6.15] resolve any ambiguity which may be said to exist in clause 6.17. The clause must be read as a whole, and the earlier provisions of the clause show that the reference to an interest in shares in clause 6.17 is to the same direct proprietary interests as appear in those provisions.

The various commercial considerations on which Mr Miles relies might, if the parties had so wished, have provided good reasons for including clear provisions to the effect that a disposal of Misland would trigger the pre-emption procedure. The absence of any such provisions in what is a complex clause, providing for many eventualities, itself tells against the suggested construction. **(p. 499)** It is a reasonable objective assumption that these sophisticated investors in a large commercial venture, and their advisers, did not overlook the possibility of a sale of Misland, particularly in the light of both the definition of 'Shareholder Group' with its special provisions for Misland and the proviso to clause 6.15. The absence of provisions dealing with a sale of a corporate shareholder is, objectively speaking, consistent with a decision by the parties not to include them …

For all these reasons, I conclude that the sale of the share capital of Misland in January 2011 was not made contrary to clause 6.17 of the shareholder agreement and did not trigger the other shareholders pre-emption rights. I reach the same conclusion on the articles and do so whether or not reference may be made to background facts …

[An appeal to the Court of Appeal by Mr McKillen was subsequently dismissed: [2012] EWCA Civ 179, CA.]

Offers to the public to purchase shares and remedies for misleading offers

When shares are offered to the public, a prospectus must be published and, additionally, when an application is made for listing on a stock exchange either a prospectus or listing particulars must be published. There are special rules about liability for errors or omissions in those documents (see Chapter 14). In practice, however, the professionalisation of the investment industry and the high standards set both by stock exchanges and by investment practitioners themselves mean that the chances of a misleading document getting into circulation in consequence of sharp or sloppy practice have been virtually eliminated.

In what follows, the special rules under the Financial Services and Markets Act 2000 (FSMA 2000) are ignored, and what is described is the general law applicable to those who have been induced by misrepresentation to subscribe for shares in a company. These rules, although of general application, are usually invoked only when the special rules on public offers are inapplicable.

The different remedies available may be summarised as follows:

(i) as against the company, rescission of the contract and consequent rectification of the share register (for material misrepresentation of *any* kind);
(ii) damages for deceit (for *fraudulent* misrepresentation);[15]
(iii) damages under the Misrepresentation Act 1967 s 2(2) (in lieu of rescission) and also possibly under s 2(1) (for so-called 'negligent' misrepresentation); and
(iv) as against the company, a possible claim in damages for breach of contract, on the basis that the statements in the prospectus or offer have been incorporated as terms of the contract.

Note that no civil remedy lies against the *company* at common law for the *omission* of information required to be included in the listing particulars or prospectus: *Re South of England Natural Gas and Petroleum Co Ltd* [1911] 1 Ch 573.

(p. 500) Misrepresentation

If a person is induced to enter into a contract by false statements of fact made by the other party, then there is a misrepresentation, and the innocent party is entitled to rescind the contract. A number of issues may prevent an allottee of shares from obtaining an appropriate remedy, however. The misrepresentation must have been made by the other party to the contract (ie by the company), be one of fact and have induced the contract.

The misrepresentation must have been made by the company.

[9.03] Lynde v Anglo-Italian Hemp Spinning Company [1896] 1 Ch 178

ROMER J: The first question I desire to deal with is this—Assuming that Mr. Waithman [a promoter] made material misrepresentations to the plaintiff which induced him to apply for the shares, could the plaintiff, on that ground, hold the company liable, and have the contract set aside? It appears to me that, speaking generally, to make a company liable for misrepresentations inducing a contract to take shares from it the shareholder must bring his case within one or other of the following heads:—(1.) Where the misrepresentations are made by the directors or other [of] the general agents of the company entitled to act and acting on its behalf—as, for example, by a prospectus issued by the authority or sanction of the directors of a company inviting subscriptions for shares; (2.) Where the misrepresentations are made by a special agent of the company while acting within the scope of his authority—as, for example, by an agent specially authorized to obtain, on behalf of the company, subscriptions for shares. This head of course includes the case of a person constituted agent by subsequent adoption of his acts; (3.) Where the company can be held affected, before the contract is complete, with the knowledge that it is induced by misrepresentations—as, for example, when the directors, on allotting shares, know, in fact, that the application for them has been induced by misrepresentations, even though made without any authority; (4.) Where the contract is made on the basis of certain representations, whether the particulars of those representations were known to the company or not, and it turns out that some of those representations were material and untrue—as, for example, if the directors of a company know when allotting that an application for shares is based on the statements contained in a prospectus, even though that prospectus was issued without authority or even before the company was formed, and even if its contents are not known to the directors.[16]

… Now, it appears to me that the plaintiff does not bring his case within any of these heads. Such misrepresentations, if any, as were made to the plaintiff were made by Mr Waithman, one of the two promoters of the company. But the company at the time had two directors entitled to act for it, and Mr Waithman was not a director or general agent of the company. No doubt the promoters had a great deal to do with the company at the time, and their wishes and views may have been highly regarded by the directors. But I see nothing to justify me in coming to the conclusion that the promoters are to be regarded as really constituting the company, or that the directors left everything in their hands, or were what may be called dummies, or left it to the promoters to do whatever they pleased in the affairs of the company. Nor was Mr Waithman, when he made the representations he did make to the plaintiff, authorized to act on behalf of the company in procuring shares or authorized to make any representations on behalf of the company to the plaintiff or others to induce him or them to apply for shares. The fact that Mr Waithman was a promoter of the company did not in itself authorize him to procure shares for the company, or to make representations to the plaintiff on the company's behalf … And although the company knew that Waithman was applying to his friends to get them to subscribe for shares, that did not, in my opinion, make him the company's agent, or put **(p. 501)** the company to inquire as to whether he had made any, and, if any, what, representations to those friends to induce them to subscribe. In most cases directors must be aware that subscriptions for shares are obtained through the intermediary of persons interested in the company, and it would lead to the most astonishing results if that was held sufficient to affect the directors with knowledge of, or to put them upon inquiry as to, the representations, if any, made by those persons to the people applying for the shares. The fact that in the case of this company some applications, including that of the plaintiff, were made on printed forms prepared by the company's solicitor does not, in my opinion, make any real difference. Mr Waithman got his forms by applying to the company's solicitor, because he wanted his friends to make proper applications for shares. No authority was given by the directors to the solicitor to supply Mr Waithman with forms, nor can the directors, by seeing these forms used, be held thereby to have adopted Mr Waithman as their agent in obtaining applications for shares. The directors did not issue any prospectus themselves or try to get applications for shares, and, no doubt, because they thought Waithman and Thomson would get a sufficient number of their friends to take up the necessary number of shares. But this did not, in my opinion, make Waithman and Thomson the special agents of the company to procure subscriptions on its behalf, or authorize them to make any representations on behalf of the company with a view of inducing their friends to subscribe.

And, lastly, this is not a case … coming at all within the fourth head. The application for shares made by the plaintiff was not one made conditional upon, or to the knowledge of the directors based upon, any special or other representations made by Waithman. The application was not even, to the knowledge of the directors, induced by representations by Waithman, though, even if it had been, whether that would in itself have been sufficient to bring the case within my fourth head or have entitled the plaintiff to rescind I need not now inquire.

On this ground, therefore, I hold that the action must fail, for in my judgment the plaintiff has not shewn any ground upon which I can rescind this contract by reason of misrepresentations, if any, made to him which induced him to apply for these shares.

[And, further, on the questions of fact, Romer J also held that the alleged misrepresentations were not made out, nor the fact that they had induced the contract.]

Loss of the remedy of rescission

The allottee will lose the right to rescission if the parties cannot be returned to their pre-contractual positions (ie if *restitutio in integrum* is no longer possible; see later), if the contract has been affirmed, if third party rights have intervened or if the allottee has delayed for too long after discovering the misrepresentation.

Rescission is not possible after an order for winding up has been made, even if the share purchase was induced by fraud.

[9.04] Oakes v Turquand and Harding (1867) LR 2 HL 325 (House of Lords)

Overend, Gurney & Co Ltd was incorporated in July 1865 to take over the long-established banking business of Overend, Gurney & Co. The prospectus issued to the public concealed the fact that the business was insolvent and had been carried on at a loss for some years. Within a year after the incorporation of the company it stopped payment and went into liquidation. In order to meet the claims of its creditors, large calls were made on the numerous members of the public who had become shareholders. Many of them combined to form a defence association, which appointed Oakes (an original allottee of shares) and Peek (who had bought shares in the market) as representatives to conduct test cases on behalf of all the shareholders. In this case they claimed that their names should be taken off the list of contributories on the ground that their contracts to take and to purchase shares, respectively, had been induced by fraud, but it was held that they had lost the right to rescind.

(p. 502) (In later proceedings (*Peek v Gurney* (1873) LR 6 HL 377) Peek was again unsuccessful, this time in a claim against the directors. Among the score or so of other reported cases arising out of the same liquidation, the best known is *Overend, Gurney & Co v Gibb and Gibb* (1872) LR 5 HL 480, in which the liquidators failed in a claim against the directors, alleging that they had been negligent in allowing the company to purchase the business.)

LORD CHELMSFORD LC: It is said that everything which is stated in the prospectus is literally true, and so it is. But the objection to it is, not that it does not state the truth as far as it goes, but that it conceals most material facts with which the public ought to have been made acquainted, the very concealment of which gives to the truth which is told the character of falsehood. If the real circumstances of the firm of Overend, Gurney & Co had been disclosed it is not very probable that any company founded upon it would have been formed. Indeed, it was admitted in the course of the argument that if the true position of the affairs of Overend, Gurney & Co had been published it would have entailed the ruin of the old firm, and would have been utterly prohibitory of the formation of the new. To which the only answer which fairly suggests itself is, ‘Then no company ought ever to have been attempted, because it was only possible to entice persons to become shareholders by improper concealment of facts' …

It is quite clear, therefore, that Oakes might originally have disaffirmed that contract, and divested himself of his shares, and that he never did any act to affirm it, nor was aware of the true state of the firm of Overend, Gurney & Co at the time of the formation of the new company, nor until after the failure …

Such was the position of Oakes when the order for winding up the company was made on 22 June 1866. His name being upon the register of shareholders, was placed (as a matter of course) by the liquidators upon the list of contributories …

On the part of the creditors, it is said that every person whose name is found upon the register at the time when the order for winding up is made is a shareholder, and liable to contribute towards the payments of the debts of the company to the extent of the sums due upon his shares, unless he can prove that his name was put upon the register without his consent.

Did the appellant then agree to become a member? His counsel answer this question in the negative; because they say that a person who is induced by fraud to enter into an agreement cannot be said to have agreed; the word 'agreed' meaning having entered into a binding agreement. But this is a fallacy. The consent which binds the will and constitutes the agreement is totally different from the motive and inducement which led to the consent. An agreement induced by fraud is certainly, in one sense, not a binding agreement, as it is entirely at the option of the person defrauded whether he will be bound by it or not. In the present case, if the company formed on the basis of the partnership of Overend, Gurney & Co had realised the expectations held out by the prospectus, the appellant would probably have retained his shares, as he would have had an undoubted right to do. But when the order for winding up came, and found him with the shares in his possession, and his name upon the register, the agreement was a subsisting one. How could it then be said that he was not a person who had agreed to become a member? To hold otherwise would be to disregard the long and well-established distinction between void and voidable contracts …

[His Lordship then held that the supervening rights of the creditors in a winding up barred the right of a member to avoid the contract on the ground of fraud. He concluded:] It only remains to observe that all that has been said with respect to Oakes applies with greater force to Peek, even if his situation as a purchaser of shares in the market did not preclude him from most of the objections which have been raised in Oakes' case.

LORD CRANWORTH and LORD COLONSAY delivered concurring opinions.

Availability of the remedy of damages

Damages are available instead of rescission, or in addition to rescission for consequential losses: (i) at common law if the misrepresentation was fraudulent (*Derry v Peek* (1889) 14 App Cas 337): see **(p. 503)** the important and detailed analysis of Lord Steyn in *Smith New Court Securities Ltd Citibank NA* [1997] AC 254; (ii) at common law for negligent misstatement;[17] and (iii) under the Misrepresentation Act 1967, but only between parties to an induced contract, for any form of misrepresentation, unless the misrepresentor can prove that he or she had reasonable grounds to believe, and did believe, up to the time the contract was made, that the facts represented were true (s 2(1)).[18]

➢ Notes

1. For over a hundred years, the rule laid down in *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317, HL, prevented a person who had been induced by fraud to take shares in a company from claiming damages against the company while he or she remained a member. The same principle was applied where damages for breach of contract were sought, based on the contract of shareholding: *Re Addlestone Linoleum Co* (1887) 37 Ch D 191, CA. The juridical basis of this rule was never satisfactorily explained, but it has now been reversed by statute: CA 2006