[19] But not debentures: see 'Issue of debentures at a discount', p 506.

[20] [1875] LR 7 HL 653, HL.

[21] As in fact happened in *Ooregum*: soon afterwards, the company struck gold and its ordinary shares rose in value from 12½p to £2.

[22] The directors would not breach any legal duty to the company (see **[9.08]**), but the existing shareholders might complain of unfairly prejudicial treatment (CA 2006 s 994). The statutory pre-emption rights are designed to help, but do not always apply or meet the problem: see 'Pre-emption rights governing the transfer of existing shares', p 497.

[23] (1869) 5 Ch App 11.

[24] (1877) 7 Ch D 75.

10. Distributions and Capital Maintenance

Chapter: (p. 512) 10. Distributions and Capital Maintenance
Author(s): Len Sealy and Sarah Worthington
DOI: 10.1093/he/9780199676446.003.0010

Controls over a company's distribution of capital

The previous chapter illustrated the concern of the law to see that those who take shares in a company do, in fact, contribute the value of their shares in money or money's worth. This fund of such contributions, being the company's legal capital, is intended by law to provide creditor protection, in some senses at the expense of the company's members. The law does not restrict every disposal of the company's assets—companies are free to run their businesses at differing rates of success. However, the ambition of creditor protection would be defeated if, once the funds had been received, companies were completely free to return them to the members, thereby adversely affecting the creditors' overall position vis-à-vis the company.

This chapter examines the rules that are designed to ensure that a company's legal capital is, as far as possible, maintained in the company's hands consistently with all the risks associated with any business venture. In particular, these rules ensure that a company's legal capital is not returned to the members themselves, directly or indirectly, except through some statutory procedure, such as a reduction of capital (Companies Act 2006 (CA 2006) ss 641ff) or a redemption or a repurchase of shares (ss 684ff), which provides proper safeguards for creditors and others who might be prejudiced by the diminution of the company's assets. In this way, the law does its best for the company's creditors who are, generally, denied any direct recourse against the members, or against the directors, whilst at the same time allowing corporate entrepreneurial activity to continue without too much state intervention.

There is, of course, only so much protection that any formal rules of law can give. In addition to the normal business risks mentioned previously, the historic figure representing the issued capital may be eroded in real terms by the effects of inflation. But these are risks which creditors necessarily accept; and UK company law does provide a further measure of protection through the publicity given to company accounts and through the remedial regime provided by the insolvency legislation.

The rules providing for 'maintenance of capital' were formulated in the first place by the courts in the latter part of the nineteenth century. But the Second EU Company Law Directive (77/91/EEC) required the UK to make specific legislative provision for many matters relating to the use of capital and the payment of dividends. The required rules to some extent overlapped with the existing judge-made law, and in other respects went much further. English statutory provisions are now more extensive than the Directive required, in that some of the provisions apply not just to public companies (as the Directive stipulated) but to private companies as well.

English statute law later introduced still further changes, in the form of rules allowing a company to repurchase its own shares.[1] This had been declared unlawful in *Trevor v Whitworth* **(p. 513)** **[10.05]**, and the common law ban is, indeed, still confirmed as a general rule in CA 2006 s 658. It also made changes to the rules related to the giving by a company of financial assistance towards the purchase of its shares. Much of the earlier case law was superseded as a result. It is not possible here to describe the detail of all the statutory rules—still less to try to explain some of their byzantine obfuscations; all that can be attempted is to summarise them, and to cite some of the relevant judicial pronouncements.

This chapter deals, in turn, with:[2]

(i) permitted returns of capital implemented by a *reduction of capital* (see 'Permitted reductions of capital', pp 513ff);
(ii) permitted returns of capital implemented by a *repurchase or redemption of shares* (see 'Redemptions and

repurchases of shares', pp 520ff);
(iii) prohibitions on a company giving *financial assistance* to others for the purchase of its shares (see 'Financial assistance by a company for the acquisition of its own shares', pp 524ff);
(iv) rules requiring *dividend distributions* to be made out of profits, not capital (see 'Dividend distributions', pp 541ff); and
(v) impermissible '*disguised' returns of capital* (see 'Disguised returns of capital', pp 548ff).

Permitted reductions of capital

Once a company has raised a particular level of legal capital, can it adjust the amount downwards? If this could happen at will, the rules on legal capital would become meaningless. On the other hand, there may be good reason for adjustments.

If the company has excess capital that it cannot, or prefers not to, use profitably in pursuing its objectives, it may wish to return this to the members rather than expand or diversify the company's business. This involves no risk to the creditors, provided they are satisfied first.

By contrast, if the company has traded unsuccessfully, the value of its existing assets may fall well short of the legal capital. Potential new equity investors may want the value of the company's existing shares to be reduced to reflect the actual value of the company's assets before new investments are made. This is desired so that, if the business is resuscitated, its profits can be paid out to members (including the new members) rather than going to meet the shortfall in undistributable legal capital. Although this type of revaluation does not involve paying any of the company's cash to its shareholders, it does have a detrimental impact on creditors: the value of the protective 'creditor buffer' is reduced, and the risk to creditors therefore increases.

CA 2006 imposes restraints on a company wishing to reduce its capital. In summary, it can only do so by: (i) special resolution confirmed by the court (CA 2006 ss 641(1)(b), 645–651); or (ii) for private companies, by special resolution supported by a solvency statement by the directors, filed with the registrar, provided that at least one shareholder will remain (ie that the share capital will not be reduced to zero) (CA 2006 ss 641(1)(a), 642–644).[3] This is a major relaxation for private companies, introduced by CA 2006. Under (i), the court must not confirm **(p. 514)** a reduction unless it is satisfied that affected creditors have consented, been paid or had their debts secured (s 648), and then the court order and the new statement of capital must be registered at Companies House. Creditors may object to the proposed reduction if it involves either a diminution of shareholder liability in respect of unpaid capital, or the payment to any shareholder of paid-up capital (s 646), unless the court thinks that creditors should not be able to object,[4] or should be able to object in an even wider range of circumstances (s 645). Subject to this, a company may reduce its capital in any way, and s 641(4) provides illustrations.

Court approval, in (i), is designed to ensure that the prescribed formalities have been strictly observed (including creditor approval), and that the reduction treats the company's shareholders fairly (see the cases cited later).

The procedure is rarely used by private companies, since they can now repurchase their own shares out of capital (see 'Redemptions and repurchases of shares', p 520), and prefer to use this approach to buy out retiring or deceased members. Public companies may still find the procedure useful on occasion. Note, too, the requirement in s 656 for directors of public companies to call a general meeting if the company's assets fall below half or less of the company's called up capital (see 'Minimum capital requirements for company formation', p 495).

Finally, where the rights of a *class* of shareholders are affected by a reduction, it may be necessary to have regard also to the provisions of CA 2006 s 630 (especially since s 630(6) indicates that references to 'variation' of class rights is taken to include references to 'abrogation'), but the approach of the courts to this topic gives less scope to that section than its draftsman probably appreciated: see **[10.03]** and **[10.01]**).

A company may not bind itself not to exercise the power conferred on it by statute to alter its capital, but an agreement by members that they will not support a resolution to alter capital is binding.

Re-read *Russell v Northern Bank Development Corpn Ltd* **[4.34]**.

➢ Question

Can the first ruling in this case (that a company cannot agree that it will not exercise its statutory power to alter its capital) be readily circumvented by the second (that members may agree by contract, either with each other or with a third party, that they will not vote for a change in the company's capital structure)? If so, is the reasoning flawed? Does the answer to this depend upon whether a court would remedy infringements by orders for specific performance or injunction, or only by orders for the payment of damages?

The court's discretion in confirming a reduction of capital.

[10.01] Scottish Insurance Corpn Ltd v Wilsons and Clyde Coal Co Ltd [1949] AC 462 (House of Lords)

The company's business had been nationalised, so that it could no longer earn profits. Its proposal to pay off the preference capital[5] in anticipation of liquidation was opposed, partly because it was believed that this would rob the preference shareholders of a right to participate in **(p. 515)** 'surplus assets' in a liquidation. The House of Lords rejected this construction of the preference shareholders' rights (see **[11.04]**) and held that the reduction was in any case fair.

> LORD SIMONDS: The Companies Act 1929, no more than its predecessors, prescribes what is to guide the court in the exercise of its discretionary jurisdiction to confirm or to refuse to confirm a reduction in capital. But I agree with the learned Lord President [in the court below] that, important though its task is to see that the procedure, by which a reduction is carried through, is formally correct and that creditors are not prejudiced, it has the further duty of satisfying itself that the scheme is fair and equitable between the different classes of shareholders: see, eg, *British and American Trustee and Finance Corpn Ltd v Couper*.[6] But what is fair and equitable must depend upon the circumstances of each case and I propose … to consider the elements on which the appellants rely for saying that this reduction is not fair to them.
>
> In the formal case which they have presented to the House the element of unfairness on which the appellants insist is that the reduction deprives them of their right to participate in the surplus assets of the company on liquidation and leaves the ordinary stockholders in sole possession of those assets. But in their argument both in the Court of Session and before your Lordships they have further relied on the fact that they have been deprived of a favourable 7% investment which they cannot hope to replace and might have expected to continue to enjoy. They further contend that the deprivation of these rights, which would in any case have been unmerited hardship, is rendered more unfair because it is likely to be followed at an early date by liquidation of the company or, as it is less accurately expressed, because it is itself only a step in the liquidation of the company.
>
> The first plea makes an assumption, viz that the articles give the preference stockholders the right in a winding up to share in surplus assets, which I for the moment accept but will later examine. Making that assumption, I yet see no validity in the plea. The company has at a stroke been deprived of the enterprise and undertaking which it has built up over many years: it is irrelevant for this purpose that the stroke is delivered by an Act of Parliament which at the same time provides some compensation. Nor can it affect the rights of the parties that the only reason why there is money available for repayment of capital is that the company has no longer an undertaking to carry on. Year by year the 7% preference dividend has been paid; of the balance of the profits some part has been distributed to the ordinary stockholders, the rest has been conserved in the business. If I ask whether year by year the directors were content to recommend, the company in general meeting to vote, a dividend which has left a margin of resources, in order that the preference stockholders might in addition to repayment of the capital share also in surplus assets, I think that directors and company alike would give an emphatic negative. Anyway they would, I think, add that they have always had it in their power, and have it still, by making use of articles 139 or 141, to see that what they had saved for themselves they do not share with others[7] … Reading these articles as a whole with such familiarity with the topic as the years have brought, I would not hesitate to say, first, that the last

thing a preference stockholder would expect to get (I do not speak here of the legal rights) would be a share of surplus assets, and that such a share would be a windfall beyond his reasonable expectations and, secondly, that he had at all times the knowledge, enforced in this case by the unusual reference in article 139 to the payment off of the preference capital, that at least he ran the risk, if the company's circumstances admitted, of such a reduction as is now proposed being submitted for confirmation by the court. Whether a man lends money to a company at 7% or subscribes for its shares carrying a cumulative preferential dividend at that rate, I do not think that he can complain of unfairness if the company, being in a position lawfully to do so, proposes to pay him off. No doubt, if the company is content not to do so, he may get something that he can never have expected but, so long as the company can lawfully repay him, whether it be months or years before a contemplated liquidation, I see no ground for the court refusing its confirmation. [His Lordship **(p. 516)** later held that the preference shareholders had in any case no right to participate in 'surplus assets' in a liquidation: see **[11.04]**.]

VISCOUNT MAUGHAM and LORD NORMAND delivered concurring opinions.

LORD MORTON OF HENRYTON dissented.

In a reduction of capital, the prima facie rule is that money is to be repaid and losses are to be borne in the order in which the different classes of shares would rank, as regards repayment or loss of capital respectively, in a winding up.

[10.02] Re Chatterley-Whitfield Collieries Ltd [1948] 2 All ER 593 (Court of Appeal)

The company's principal business had been nationalised. It proposed to continue operations on a much smaller scale, for which it would need far less capital. It therefore proposed to reduce its capital by paying off its preference shareholders, leaving the ordinary shareholders unaffected. This was confirmed by the court as fair, since it was in accordance with the respective rights of the two classes in a winding up.

LORD GREENE MR: [T]he company is faced with the following situation. Its principal business has gone and it is proposing to embark on certain new activities which may or may not turn out to be successful. So long as it was possessed of its colliery it clearly required to keep all its issued capital in the business—there was no question of its having capital surplus to its business requirements. The reduced form of its activities is, however, such that it has a great deal more capital than it requires …

What is a company in that situation to do? The business answer to this question does not admit of doubt, particularly where a substantial part of its capital consists of preference shares bearing a higher rate of dividend than the company is reasonably likely to earn in the future. It will do what this company seeks to do, ie reduce its capital by paying off as much of its preference capital as it is able to pay off out of its surplus. A company which satisfies its capital requirements by issuing preference shares only does so where it is satisfied that the new capital will earn at least the promised rate of dividend. A company which has issued preference shares carrying a high rate of dividend and finds its business so curtailed that it has capital surplus to its requirements and sees the likelihood, or at any rate the possibility, that its preference capital will not, if I may use the expression, 'earn its keep', would be guilty of financial ineptitude if it did not take steps to reduce its capital by paying off preference capital so far as the law allowed it to do so. That is mere commonplace in company finance.

There has been a tendency, indeed more than a tendency, to represent a company confronted by this sort of practical question as though it were nothing but an uneasy and warring combination of hostile classes of shareholders. In a sense, no doubt, it is. But it is more than this. The position of the company itself as an economic entity must be considered, and nothing can be more destructive of a company's financial equilibrium than to have to carry the burden of capital which it does not need, bearing a high rate of dividend which it cannot earn. In a company so situated, the ordinary shareholders will be unfairly treated vis-à-vis the preference shareholders, and the company may well fall into the situation when its preference dividends will begin to fall into irretrievable arrears. It is a fallacy to suppose that because ordinary shareholders will

benefit, the transaction ought to be vetoed as being unfair to the preference shareholders.

It is a clearly recognised principle that the court, in confirming a reduction by the payment off of capital surplus to a company's needs, will allow, or rather require, that the reduction shall be effected in the first instance by payment off of capital which is entitled to priority in a winding up. Apart from special cases where by agreement between classes the incidence of reduction is arranged in a different manner, this is and has for years been the normal recognised practice of the **(p. 517)** courts, accepted by the courts and by businessmen as the fair and equitable method of carrying out a reduction by payment off of surplus capital. I know of no case where this method has, apart from agreement, been departed from …

In the result, I am of opinion that the present appeal should be allowed and the proposed reduction confirmed, the application being otherwise in order.

ASQUITH LJ delivered a concurring judgment.

EVERSHED LJ dissented.

This decision was affirmed by the House of Lords: *Prudential Assurance Co Ltd v Chatterley-Whitfield Collieries Ltd* [1949] AC 512.

Subject to the Act and the company's articles,*[8] *no separate class meetings are necessary to approve a reduction of capital if priority is given to the different classes in accordance with the terms on which they were issued.

[10.03] Re Saltdean Estate Co Ltd [1968] 1 WLR 1844 (Chancery Division)

The company's preferred shareholders were entitled to participate in the 'balance of profits' in each year after a 10% preferred dividend and an equivalent sum in dividends on the ordinary shares had been paid; but in a winding up they had no right to participate in surplus capital. The ordinary shareholders controlled the voting. The court was asked to confirm a reduction of capital which was to be effected by paying off the preferred shares at 75p per 50p share. The reduction was approved by the court, which ruled that there was no 'variation' of the preferred shareholders' rights which would call for approval by a separate class meeting.

BUCKLEY J: [It] is said that the proposed cancellation of the preferred shares will constitute an abrogation of all the rights attached to those shares which cannot validly be effected without an extraordinary resolution of a class meeting of preferred shareholders under article 8 of the company's articles. In my judgment, that article has no application to a cancellation of shares on a reduction of capital which is in accord with the rights attached to the shares of the company. Unless this reduction can be shown to be unfair to the preferred shareholders on other grounds, it is in accordance with the right and liability to prior repayment of capital attached to their shares. The liability to prior repayment on a reduction of capital, corresponding to their right to prior return of capital in a winding up is a liability of a kind of which Lord Greene MR [in the *Chatterley-Whitfield* case **[10.02]**] said that anyone has only himself to blame if he does not know it. It is part of the bargain between the shareholders and forms an integral part of the definition or delimitation of the bundle of rights which make up a preferred share. Giving effect to it does not involve the variation or abrogation of any right attached to such a share. Nor, in my judgment, has s 72 of the Companies Act 1948 [CA 2006 s 633], upon which the opponents place some reliance, any application to this case. That section relates to variation of rights attached to shares, not to cancellation of shares …

The fact is that every holder of preferred shares of the company has always been at risk that his hope of participating in undrawn or future profits of the company might be frustrated at any time by a liquidation of the company or a reduction of its capital properly resolved upon by a sufficient majority of his fellow members. This vulnerability is, and always has been, a characteristic of the preferred shares. Now that the event has occurred, none of the preferred shareholders can, in my judgment, assert that the resulting state of affairs is unfair to him.

For these reasons the opposition to this petition, in my judgment, fails.

(p. 518) ➢ Notes

1. In *House of Fraser plc v ACGE Investments Ltd* [1987] AC 387, HL, the House of Lords endorsed this decision, and approved the following passage from one of the judgments in the court below (1987 SLT 273 at 278):

> In our opinion the proposed cancellation of the preference shares would involve fulfilment or satisfaction of the contractual rights of the shareholders, and would not involve any variation of their rights. Variation of a right presupposes the existence of the right, the variation of the right, and the subsequent continued existence of the right as varied. A different situation obtains where a right is fulfilled and satisfied and thereafter ceases to exist.

2. These rulings do not apply where the company's articles of association expressly provide that the rights attached to a class of shares shall be deemed to be varied by a reduction of the capital paid up on the shares. A separate class meeting must then be held: *Re Northern Engineering Industries plc* [1994] 2 BCLC 704, CA.

➢ Questions

1. How do these decisions relate to the statutory provision in CA 2006 s 630, especially s 630(6) which indicates that references to a 'variation' of class rights is taken to include references to 'abrogation'? (See 'Variation of class rights, pp 563ff, and *Re Northern Engineering Industries plc*, in the previous Note 2.)

2. If the company has a *shortfall* of capital, how should a capital reduction be implemented as between the company's ordinary shareholders (class A), preference shareholders with a preferential right to both a dividend and a return of capital on a winding up (class B) and preference shareholders with only a preferential right to a dividend (class C)?

3. If the company has a *surplus* of capital, how should a capital reduction be implemented as between the company's ordinary shareholders (class A), preference shareholders with a preferential right to both a dividend and a return of capital on a winding up (class B) and preference shareholders with only a preferential right to a dividend (class C)?

A shareholder voting at a class meeting held in connection with a reduction of capital must have regard to the interests of the class of shareholders as a whole.

[10.04] Re Holders Investment Trust Ltd [1971] 1 WLR 583 (Chancery Division)

The company petitioned for confirmation of a reduction of capital, under which it was proposed to cancel its redeemable preference shares and to allot to the holders an equivalent amount of unsecured loan stock.[9] The reduction was approved by both a special resolution of the company and an extraordinary resolution of a separate class meeting of the preference shareholders. At the latter meeting, some 90% of the votes cast were held by certain trustees (referred to in the judgment as 'the supporting trustees') who also held about 52% of the ordinary stocks and shares, and in that respect stood to gain substantially from the reduction. Megarry J held that the vote at the class meeting was ineffectual, because the majority preference shareholders had considered their own interests, without regard to what was best for the preference shareholders as a class. **(p. 519)**

MEGARRY J: Unopposed petitions by a company for the confirmation of a reduction of capital are a commonplace of the Companies' Court; but an opposed petition such as the one I have before me is a comparative rarity …

Put briefly, Mr Drake's opposition to the confirmation of the reduction is twofold. First, he contends that the extraordinary resolution of the preference shareholders was not valid and effectual because the supporting trustees did not exercise their votes in the way that they ought to have done, namely, in the interests of the preference shareholders as a whole. Instead, being owners of much ordinary stock and many shares as well, they voted in such a way as to benefit the totality of the stocks and shares that they held. Secondly, Mr Drake contends that even if the extraordinary resolution was valid, the terms on which the reduction of capital is to be effected are not fair, in particular in that the increase in the rate of interest from 5% to 6% is not an adequate recompense for having the right of repayment or redemption postponed from 31 July 1971, until at earliest 31 October 1985, and at latest some unspecified date in 1990. I may say at the outset that it is common ground that the proposed reduction is not in accordance with the class rights of the preference shareholders …

[His Lordship referred to *Carruth v ICI Ltd*,[10] *British America Nickel Corpn Ltd v MJ O'Brien Ltd* **[11.06]** and *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* **[6.06]**and continued:]

In the *British America* case, Viscount Haldane, in speaking for a strong Board of the Judicial Committee, referred to 'a general principle, which is applicable to all authorities conferred on majorities of classes enabling them to bind minorities; namely, that the power given must be exercised for the purpose of benefiting the class as a whole, and not merely individual members only …' The matter may, I think, be put in the way in which Scrutton LJ put it in the *Shuttleworth* case, where the question was the benefit of the company rather than of a particular class of members. Adapting his language … I have to see whether the majority was honestly endeavouring to decide and act for the benefit of the class as a whole, rather than with a view to the interests of some of the class and against that of others …

I pause here to point the obvious. Without guidance from those skilled in these matters, many members of a class may fail to realise what they should bear in mind when deciding how to vote at a class meeting. The beneficial owner of shares may well concentrate on his own personal interests: even though he regards the proposal per se as one to be rejected, collateral matters affecting other interests of his may lead him to vote in favour of the resolution. Trustees, too, are under a fiduciary duty to do the best they properly can for their beneficiaries. A proposal which, in isolation, is contrary to the interests of those owning the shares affected may nevertheless be beneficial to the beneficiaries by reason of the improved prospects that the proposal will confer on other shares in the company which the trustees hold on the same trusts: and that, in essence, is what is in issue here …

[His Lordship referred to correspondence between the 'supporting trustees' and their professional advisers, and continued:] That exchange of letters seems to me to make it perfectly clear that the advice sought, the advice given, and the advice acted upon, was all on the basis of what was for the benefit of the trusts as a whole, having regard to their large holdings of the equity capital. From the point of view of equity, and disregarding company law, this is a perfectly proper basis; but that is not the question before me. I have to determine whether the supporting trustees voted for the reduction in the bona fide belief that they were acting in the interests of the general body of members of that class. From first to last I can see no evidence that the trustees ever applied their minds to what under company law was the right question, or that they ever had the bona fide belief that is requisite for an effectual sanction of the reduction. Accordingly, in my judgment there has been no effectual sanction for the modification of class rights …

[His Lordship considered the evidence, and ruled that the reduction had not been shown to be fair to the preference shareholders. Accordingly, he refused to confirm the reduction.]

 ➢ Notes

1. This case was decided at common law, before the enactment of the statutory provisions on class rights which are now to be found in CA 2006 ss 630ff.

2. In this case, it might be said that Megarry J is expecting the majority preference shareholders to show a 'detached altruism' which the court in such cases as *Mills v Mills***[7.13]** dismissed as unrealistic. See LS Sealy, 'Equitable and Other Fetters on the Shareholder's Freedom to Vote' in NE Eastham and B Krivy (eds), *The Cambridge Lectures 1981*, attacking the rule as wrong. What *is* expected of shareholders? A good number of cases suggest that some restrictions on voting are appropriate. Are such cases all best explained as illustrating judicial review of powers which are subject to equitable 'proper purposes' restrictions (although not, with shareholders, fiduciary loyalty constraints) (see Chapter 14 generally)?

3. The same judgment also set out the parties' respective burdens of proof (at 586):

> If there is [effective sanction by the majority], the court will confirm the reduction unless the opposition proves that it is unfair; if there is not, the court will confirm the reduction only if it is proved to be fair. [And so, on finding that there was no effectual sanction in this case, His Lordship held, at 589, that the burden here rested on those supporting the reduction to prove that it was fair.]

4. These prohibitions on return of capital apply equally to disguised returns of capital: see 'Disguised returns of capital', pp 548ff.

Redemptions and repurchases of shares

The general rule in CA 2006 s 658 is that a company is not permitted to acquire its own shares, except in accordance with the Act. Any contravention is an offence committed by the company and by every officer in default, and the purported acquisition of shares is void. This provision confirms the rule established at common law by*Trevor v Whitworth* **[10.05]**, which recognised the issue was not a domestic matter concerned with compliance with the articles, or even a question of *vires* dependent upon the powers set out in the memorandum, but a matter of legality under the Companies Act itself.

In fact, both law and practice in this area have moved well away from the restrictive attitudes embodied in the general rule. This is because the general prohibition is subject to a number of substantial statutory exceptions, the most significant being the various rules permitting companies to *redeem* and to *repurchase* their own shares in defined circumstances. It is now quite common to see listed public companies advertise billion pound on-market and off-market share buy-backs, usually at a discount to the market price. The exercise demonstrates the company's commitment to capital discipline, and the terms maximise the economic value for the remaining shareholders, who benefit from the enhanced value of their shares through increased value and returns attributable to each share. The repurchase is, in effect, a judgement by the company that its shares are undervalued and represent a better investment than any available alternative acquisition of assets or investment in a business opportunity it owns or to which it has access. Any redemption or repurchase effected otherwise than in full compliance with the statutory rules will not displace the general prohibition, however, so the purported transaction will be void. This makes it important to address the technical details of the Act very carefully. The repurchased shares are either cancelled or held by the company as so-called 'treasury shares' until cancelled or subjected to some other permitted disposal (see 'Protection of shareholders', p 523).

(p. 521) ***General rule: it is illegal for a company to acquire its own shares, except as provided in CA 2006.***

[10.05] Trevor v Whitworth (1887) 12 App Cas 409 (House of Lords)

> LORD WATSON: … One of the main objects contemplated by the legislature, in restricting the power of limited companies to reduce the amount of their capital as set forth in the memorandum, is to protect the

> interests of the outside public who may become their creditors. In my opinion the effect of these statutory restrictions is to prohibit every transaction between a company and a shareholder, by means of which the money already paid to the company in respect of his shares is returned to him, unless the court has sanctioned the transaction. Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business.
>
> When a share is forfeited or surrendered, the amount which has been paid upon it remains with the company, the shareholder being relieved of liability for future calls, whilst the share itself reverts to the company, bears no dividend, and may be re-issued. When shares are purchased at par, and transferred to the company, the result is very different. The amount paid up on the shares is returned to the shareholder; and in the event of the company continuing to hold the shares (as in the present case) is permanently withdrawn from its trading capital. It appears to me that … it is inconsistent with the essential nature of a company that it should become a member of itself. It cannot be registered as a shareholder to the effect of becoming debtor to itself for calls, or of being placed on the list of contributories in its own liquidation …

General exceptions to the prohibition in CA 2006 s 658

CA 2006 s 659 provides particular exceptions to the general prohibition in s 658.

These include instances where the company's *fully paid* shares are acquired for no consideration, so there is no detriment to creditors because the company's legal capital is unaffected.

It also includes instances where a court has ordered or approved the acquisition (eg by way of formal reduction of capital (see earlier), or by court order following complaints of unfair prejudice (see 'Unfairly prejudicial conduct of the company's affairs', pp 681ff)), or where the company has acquired its shares by forfeiture or surrender for non-payment of calls.[11]

Shares so acquired by a *public* company or by a nominee on its behalf must normally be cancelled within a maximum period of three years (one year in the case of shares which have been purchased by third parties with direct or indirect financial assistance from the company (see 'Financial assistance by a company for the acquisition of its own shares', pp 524ff)), and the company's share capital reduced accordingly, and pending cancellation or disposal no voting rights may be exercised in respect of those shares (s 662). If this were permitted, the directors of the company would have a voting power disproportionate to their personal stake as shareholders. (We may quite reasonably ask why these rules, including the prohibition on voting, are restricted to public companies.)

(p. 522) Redeemable shares

CA 2006 s 684 permits a company to issue redeemable shares if authorised by its articles (public companies) or if not prohibited by its articles (private companies), and so long as the company also has issued shares that are not redeemable.

CA 2006 ss 685–689 provide rules for the issue and redemption of such shares. Note that:

(i) the terms on which redeemable shares are issued is determined by the directors, provided they are authorised by the articles or by an ordinary resolution (even if this ordinary resolution effects a change to the articles) (s 685);
(ii) shares cannot be redeemed unless they are fully paid (s 686);
(iii) the shares must be paid for in full on redemption, unless the agreement between the company and holder allows for deferred payment (s 686);
(iv) private companies can redeem shares out of capital (although only subject to the onerous condition in ss

709–723, including a requirement for a directors' statement and an auditor's report, and a right for members and creditors to apply to court for the cancellation of the resolution); public companies must redeem out of distributable profits (see 'Current position', pp 542ff) or from the proceeds of a new share issue made for the purpose (s 687);
(v) redeemed shares must then be cancelled, and the company must reduce its issued share capital by the nominal value of the cancelled shares (s 688);
(vi) to the extent that the redemption is made out of profits, the company must also transfer an amount equivalent to the nominal value of the redeemed shares to a new capital account called the '*capital redemption reserve*', which can only be reduced by transfer to the share capital account to pay up fully paid bonus shares, or otherwise as if it were part of the paid up share capital (s 733). In effect, this means that the company must have available a surplus equivalent to double the funds needed to effect the repurchase, and one-half has to be set aside and treated as capital thereafter.
(vii) there are extensive disclosure provisions.

Repurchase of shares

The essential difference between a *repurchase* and a *redemption* is as follows: in the former, the buyer and seller need to agree to the terms and conditions of repurchase at the time of the repurchase; whereas with the latter, the shares will have been issued as redeemable shares, so that the terms and conditions of the reacquisition will be known from the outset. Subject to that essential difference, however, the two transactions are treated by CA 2006 in broadly similar ways.

A company's power to repurchase its own shares is broad: subject to any constraints or prohibitions in the company's articles, a company may repurchase its shares in accordance with the rules set out in CA 2006 ss 690ff.

Again, it is necessary to pay strict attention to the detailed wording of the Act itself, although with the warning that these sections are long-winded and not easy to follow. Note that different rules apply to:

(i) a purchase by a company of its own shares *off the market*: a special resolution is necessary, and for public companies this authority cannot be granted for longer than 18 months (ss 694, 697 and 700); the shareholders whose shares are to be repurchased cannot be counted in the vote (ss 695 and 698);
(ii) a purchase by a (public) company of its own shares *on the market*: an ordinary resolution is required (s 701); the authority granted may be general or specific, and unconditional or conditional, but this authority cannot be granted for longer than 18 months.

(p. 523) Note, too, that:

(i) the company's right to repurchase its shares cannot be assigned (s 704);
(ii) shares cannot be repurchased unless fully paid (s 691);
(iii) the shares must be paid for in full at the time of repurchase (s 691);
(iv) the permitted sources of the purchase funds for repurchases by private and public companies are the same as for redemptions (see earlier) (ss 692 and 705), and when a private company uses capital to fund the purchase a declaration of solvency is needed;
(v) the rules on creation of a capital redemption reserve are the same as for redemptions (see earlier) (s 733);
(vi) the repurchased shares must be cancelled, and the company must reduce its issued share capital by the nominal value of the cancelled shares, *unless* the shares can be held and dealt with as '*treasury shares*'[12] in accordance with ss 724ff (s 706); and
(vii) there are extensive disclosure provisions.

Protection of shareholders

The rules discussed in this section are primarily aimed at protecting creditors while allowing companies to use their resources in an efficient and financially sensible manner. But the rules have built-in protections for both exiting and remaining shareholders that are worth noting: