The City Takeover Panel

So far as the Panel and the City Code are concerned the position is as follows:

- Since treasury shares have few rights attached to them the provisions of the City Code and the rules governing substantial acquisitions of shares will not apply to them.
- A sale and transfer by the company of treasury shares will normally be treated like a new issue.

Financial assistance for the purchase of shares

Previous position

The prohibition on the giving by companies of financial assistance for the purchase of their own shares or the shares of their holding companies by someone other than the company was introduced by the Companies Act 1929 and retained in subsequent legislation until 1981.

The object was largely to defeat the asset stripper who might, for example, acquire shares in a company by means of a loan from a third party so that he came to control it and once in control could repay the loan from the company's funds and then sell off its assets leaving the company to go into liquidation with no assets to meet the claims of creditors. The company concerned was usually one whose shares were, perhaps because of the management policies of the board, undervalued.

The sanction of the law designed to deter this sort of activity was a default fine which could be levied following criminal proceedings.

However, following cases such as ***Heald* v *O'Connor*** [1971] 2 All ER 1105, it was realised that there were civil law consequences since the transactions surrounding the acquisition of the company were illegal. Thus, the loan by the third party was void and irrecoverable at law; if the company had given the lender a debenture to secure the loan, or a guarantee to repay it, these securities were void and unenforceable, as was any guarantee or other security given by anyone else including the asset stripper himself.

The same civil law consequences would apply in so far as a person infringed the present law set out below. Breach of the present law is stated to be 'unlawful' and is attended as before by criminal sanctions, the maximum penalty being a term of imprisonment of two years and/or a fine of unlimited amount.

Problems created by previous legislation

The rule against the giving of financial assistance struck potentially at ordinary commercial transactions of companies as follows:

(a) Management buy-outs

This is the disposal of a company to its management. A holding company may use a buy-out to sell off a subsidiary whose business though successful does not fit the current development plan of the group.

However, the buy-out is more common in the case of private free-standing companies. Suppose that in a family business senior management has reached the age of retirement and is unable to find any purchaser of the business, who knows and can run it successfully other than those employees who are coming up as the next generation of management. In such a case those in management below the owner/directors may use a buy-out technique to acquire the business with the blessing of the owner/directors (but see ***Brady*** **v** ***Brady*** [1988] 2 All ER 617, below).

A management buy-out is commonly achieved by a bank lending the managers the money to buy the shares. Typically the managers can only provide between 10 and 20 per cent of the funds required. The loan is often secured on the assets of the company which management is acquiring and this is the giving of financial assistance and was an infringement of previous legislation.

Nevertheless, it was a popular and useful technique which regrettably operated outside the law.

(b) Other transactions

It was held by the Court of Appeal in ***Belmont Finance*** **v** ***Williams (No 2)*** [1980] 1 All ER 393 that there was an infringement of then existing legislation when Company A bought the share capital of Company B at an over-inflated price and the former owner of Company B used the money to buy shares in Company A.

Belmont Finance was a member of the Williams group of companies and engaged in property development. The directors of Belmont were anxious to get the 'expertise and flair in property development' of a Mr Grosscurth on the Belmont board, but he wanted to be a substantial shareholder in Belmont as well. Mr Grosscurth owned Maximum Finance which was worth £60,000. Belmont agreed to buy Maximum Finance for £500,000 and Mr Grosscurth used that money to buy a substantial stake in Belmont. In later proceedings this transaction, which obviously reduced the net assets of Belmont, was regarded as unlawful financial assistance by Belmont.

Finally, there were even lawyers prepared to state that the purchase of shares in a company by an innocent recipient of dividends from it might be infringing the financial assistance rule.

Thus, some not uncommon commercial transactions were rendered illegal by a rule which was not, it seems, intended to catch all of them.

The Companies Act 2006

The Companies Act 2006 eventually did not implement a number of the Company Law Review proposals to amend the rules relating to financial assistance as applicable to public limited companies. As such, the law is only slightly amended to that found in the previous Act. However, the main change that has taken place under the 2006 Act has been to take private limited companies out of the scope of this rule as contained in ss 677–683.

The prohibition

Under s 678(1) of the Companies Act 2006, it is unlawful for a public company to give a person financial assistance for the purchase of its own shares or those of its holding company, directly or indirectly, for the purpose of the acquisition before or at the same time as the shares are acquired. Section 678(3) goes on to provide that where a person has acquired shares in a company and a liability has been incurred for the purpose of the acquisition, it is not lawful for that company to give financial assistance, directly or indirectly, for the purpose of reducing or discharging the liability if, at the time the assistance is given, the company in which the shares were acquired is a public company.

There is no prohibition on a subsidiary company providing financial assistance for the purchase of shares in its fellow subsidiaries or in a holding company providing assistance for the purchase of shares in one of its subsidiaries. As we have seen, the prohibition is extended to assistance after acquisition as where A borrows money to acquire shares in B Ltd and B Ltd later repays the loan or reimburses A after A has repaid the loan. In this regard, the reference to 'a person' is not confined to individuals but includes registered companies and other corporate bodies.

Section 683 goes on to provide definitions for the following terms outlined within the chapter of the Act: 'distributable profits'; 'distribution'; 'a person incurring liability'; and 'a company giving financial assistance'.

However, a considerable amount relating to the prohibition under s 678 relies upon the definition of the term 'financial assistance' as outlined in s 677 of the Companies Act 2006.

Meaning of financial assistance

Financial assistance is provided if the company concerned makes a gift of the shares or a gift of funds to buy them; or guarantees a loan used to buy its shares; or gives an indemnity to the lender; or secures the loan by giving a charge over its assets to the lender. A company would also give assistance if it waived or released, for example, its right to recover a debt from a person A so that A could use the funds to buy shares in the company.

The 2006 Act also contains a 'sweep-up' provision contained in s 677(1)(d), which refers to 'any other financial assistance given by a company where (i) the net assets of the company are reduced to a material extent by the giving of the assistance; or (ii) the company has no net assets'. In other words, this provides a 'catch-all' provision that may include anything not specifically mentioned elsewhere within s 677(1). The test is not liquidity but net worth based on the actual value of the assets. Thus, a purchase by a company for cash at market value of a fixed asset from a person who later bought its shares would not be financial assistance because the company's net assets would not be reduced and cash would be replaced by the assets.

However, the section would catch artificial transactions affecting a company's assets, as where the company paid twice the market value for an asset in order to enable the seller to buy its shares.

Thus, as we have seen, in ***Belmont*** the actual transaction was artificial and designed purely to assist the owner of Company B to acquire shares in A at the expense of the assets of A, because Company A paid far more for the shares of B than they were worth, i.e. £500,000 against a valuation of £60,000. The actual deal in ***Belmont*** would thus infringe this, although what happened is not otherwise a forbidden transaction.

'Net assets' is defined under s 677(2) as the aggregate assets less the aggregate liabilities determined by reference to their actual rather than their book value. With respect to interpreting s 678, it is worth looking at the case of ***Brady*** v ***Brady***, 1988, where the House of Lords held unanimously that the 'good faith' requirements had been complied with whilst the purpose ones had not.

Brady* v *Brady [1988] 2 All ER 617 HL

The first plaintiff and first defendant were brothers who carried on a family business through B Ltd. They argued, and the first plaintiff petitioned under what is now s 994 of the Companies Act 2006 for an order to buy out the first defendant or for the company to be wound up. An agreement was reached whereby one brother (Jack) would acquire the haulage side of the business and the other

(Bob) the drinks business, the assets being divided equally with B Ltd left in existence. The defendants then took the view that the assets had not been divided equally and refused to complete. The plaintiffs sued for specific performance. At the trial, the defendants contended only that the agreement had been illegal and *ultra vires* since it required B Ltd to dispose of its assets without consideration, and that the proposed arrangements constituted the giving by B Ltd of financial assistance in connection with the purchase of its own shares contrary to what is now s 678 of the Companies Act 2006. The judge held that the principal purpose of the giving of financial assistance was not to reduce or discharge any liability incurred by any person for the acquisition of shares, but was incidental to the larger purpose of the arrangement and fell within the exception in s 153(2) of the Act. He granted the order of specific performance.

Held – by the House of Lords – that the transfer of assets from B Ltd was *intra vires* and made in good faith and so came within the scope of s 153(2)(b) of the Companies Act 1985 (now s 678(4) of the 2006 Act). But the financial assistance had not been an incidental part of some larger purpose of the company within s 153(2)(a) and so prima facie it did not fall within the exception to the prohibition of what is now s 678 of the Companies Act 2006 against a company giving financial assistance for the acquisition of its own shares. However, there was a conclusive answer to the agreement being rendered unlawful, whereby a private company could give financial assistance for the acquisition of its own shares if the assets of the company providing the assistance were not reduced by the provision of the assistance, or if the assistance was provided out of distributable profits. Since B Ltd could satisfy those provisions, a decree of specific performance would be granted, subject to the defendants being given an opportunity to reinstate defences they had abandoned.

Comment

(i) The House of Lords said that it was not enough to show that there were 'other reasons' for the assistance being given. Reasons were not the same as 'a larger purpose of the company'. In this regard, Lord Oliver noted:

> The ambit of the operation of the section is, however, far from easy to discern, for the word 'purpose' is capable of several different shades of meaning. This much is clear, that paragraph (a) is contemplating two alternative situations. The first envisages a principal and, by implication, a subsidiary purpose. The inquiry here is whether the assistance given was principally in order to relieve the purchaser of shares in the company of his indebtedness resulting from the acquisition or whether it was principally for some other purpose – for instance, the acquisition from the purchaser of some asset which the company requires for its business. That is the situation envisaged by Buckley LJ in the course of his judgment in the ***Belmont Finance*** case as giving rise to doubts. That is not this case, for the purpose of the assistance here was simply and solely to reduce the indebtedness incurred by Motoreal on issuing the loan stock. The alternative situation is where it is not suggested that the financial assistance was intended to achieve any other object than the reduction or discharge of the indebtedness but where that result (i.e. the reduction or discharge) is merely incidental to some larger purpose of the company. Those last three words are important. What has to be sought is some larger overall corporate purpose in which the resultant reduction or discharge is merely incidental.

(ii) Although the decision is not concerned with a management buy-out but rather a company reconstruction, it could be said that a management buy-out is the 'reason' for the assistance and not 'a larger purpose of the company'.

As we have seen, it is necessary to find 'a larger purpose of the company' of which the giving of assistance is merely an incident. Clearly, if A sells an asset to B Ltd at the proper market price and uses the money to buy shares in B Ltd, then the assistance is exempt because B Ltd has 'a larger purpose' (i.e. the acquisition of the asset), but in the management buy-out it may be a struggle to convince the court that there is a 'larger purpose of the company'.

When is financial assistance lawful?

(1) The giving of financial assistance is lawful if the principal purpose of the company's action is not to give financial assistance OR such assistance is given as an incidental part of some larger purpose of the company. In addition, the assistance MUST be given in good faith and in the best interests of the company giving the assistance.

The company's defence, therefore, is founded upon the purpose in giving assistance and since this is a matter of fact to be decided on the evidence it would be as well for the purpose to be set out clearly in the relevant board minutes. A purpose must be established other than the mere giving of assistance and there is also a good faith and best interests of the company requirement. This should prevent the kind of asset stripping referred to at the beginning of this section although there is little doubt that some, seeking to gain profit from purely artificial transactions at the expense of a company's assets, will try to dress up their dealings as some form, for example, of 'reconstruction'.

However, a legitimate management buy-out is hopefully allowed and other ordinary commercial transactions are no longer threatened by illegality. For example, A acquires B. B wishes to transfer its bank balances to A to effect a more efficient disposition of funds within the group. The boards of A and B may both know that A intends to use those balances to reduce indebtedness, e.g. a loan incurred as a result of acquiring B, but this is permitted because reduction of such indebtedness is merely incidental to a larger corporate purpose.

(2) The following are also permitted under s 681:

(a) A distribution of assets in Company A by way of dividend or in a winding-up where the distribution is used to buy shares in A or in its holding company or in the case of winding-up A's former holding company (s 681(2)(a)).

(b) An allotment of bonus shares – which in a sense the company assists the shareholders concerned to acquire (the provisions relating to assistance cover acquisition of shares other than for cash but bonus shares are specifically exempt) (s 681(2)(b)).

(c) Any arrangement or compromise under s 110 and Part I of the Insolvency Act 1986, which results, for example, in a liquidator transferring the assets of Company A to Company B so that the shareholders of A receive shares in B into which A is merged which in a sense A's assets have assisted them to acquire (s 681(2)(f)).

(c) Where the funds used for the purchase of the shares in the company or its holding company arise from:
- a reduction of its capital under Chapter 10 of Part 17 of the 2006 Act (s 681(2)(c)); or
- a redemption or purchase of its shares under Chapter 3 and Chapter 4 of Part 18 of the 2006 Act (s 681(2)(d)).

In the case where a company is reducing its share capital the money received by the shareholder in the reduction is most likely to be used to buy shares in the holding company.

(d) A company may lend money to a person which he uses to acquire shares in it or its holding company if lending money is part of the ordinary business of the company as is the case with a bank (s 682(2)(a)). The fact that a company has power to lend money by its memorandum does not make lending money part of its ordinary business unless making loans is one of its main business activities. Neither the loans it ordinarily makes nor the loan which facilitates the acquisition of the shares must be made for the specific purpose of acquiring the shares. The borrower must be free to use the loan as he wishes, and it must be merely coincidental that the borrower uses it to buy shares in the company.

So if a person gets a general loan or an overdraft from a bank and uses it or part of it to buy shares in the bank, there is no illegal financial assistance.

(e) The provision by a company, in good faith in the interests of the company, of financial assistance for the purposes of an employees' share scheme is permitted (s 681(2)(b)). This means that assistance is not limited to the provision of money for the acquisition of shares but applies to all forms of assistance for the purposes of an employees' share scheme, e.g. repaying some or all of the borrowings taken out by the scheme in order to buy the company's shares. The giving of guarantees of loans to acquire the company's shares would also be included. A company may finance an employees' share scheme which benefits employees of the group and their dependants and not merely employees of the company. Employee/directors may be included in such a scheme.

(f) A company may make loans to its employees, other than directors, to enable them to subscribe for or purchase fully paid shares in the company or its holding company to be held by them in their own right (s 682(2)(d)).

It should be noted that the lending set out in points (d)–(f) above is permissible in the case of a public company only if the company's net assets are not thereby reduced, or, to the extent that those assets are thereby reduced, if the financial assistance is provided out of profits which are available for dividend. 'Net assets' in relation to a company for this purpose means the aggregate of that company's assets less the aggregate of its liabilities, including provisions, determined by their book value.

Finally, if shares are acquired by a nominee for a public company (not any other person) with financial assistance from the company, then (apart from any infringement of the general law) no voting rights may be exercised by that nominee and any purported exercise of such rights is void. Secondly, the company must dispose of the shares within one year and if this is not done it must cancel them. If the shares are cancelled and the cancellation has the effect of reducing the company's allotted share capital below the authorised minimum, the directors must apply for the company to be re-registered as a private company. Only a directors' resolution is required to make the necessary reduction, application and any alterations to the memorandum that are necessary. There is no need to apply to the court to obtain confirmation of the reduction but any resolution passed by the directors must be filed with the Registrar.

It is worth noting at this point that the 2006 Act does not prohibit a foreign subsidiary from giving financial assistance for the acquisition of shares in its English parent company. There is no need in such a case to follow the 1985 Act procedures. The authority for this is ***Arab Bank plc*** v ***Mercantile Holdings Ltd*** [1994] 2 All ER 74.

Relaxation of restrictions: private companies

As noted at the beginning of this section, the Companies Act 2006 has removed the financial assistance prohibition from private companies. Consequently, s 678 only applies to the provision of financial assistance being provided in relation to a public company.

Sanctions for breach of financial assistance rules

Under s 680, the consequences of a breach of the financial assistance rules are considerable, as the following summary shows:

- It is a criminal offence. The company giving the assistance is liable to a fine and the officers in default are liable to imprisonment and/or a fine.
- The company and its officers can be sued and required to compensate any person who suffers loss as a consequence of their unlawful actions.
- Breach of the rules is a breach of fiduciary duty by a director for which the company can claim damages.

***Re Hill and Tyler Ltd* (*In Administration*)** [2004] EWHC 1261 (Ch)

This was an application by the administrators of a company for directions as to whether arrangements made in the course of the purchase of shares in the company by another company, and in particular security given to the respondents as part of those arrangements, constituted unlawful financial assistance by the company under s 151 of the Companies Act 1985 (now s 678 of the Companies Act 2006); the issues included the validity of a statutory declaration by the company's director and, if it was invalid, the consequence of this on the security provided by the company to the respondents and a loan made by the second respondent to the company. Richard Sheldon QC stated:

> The argument can be broken down into three questions: (1) Is a contract involving the provision of financial assistance in contravention of s 151, even where the whitewash procedure is available but not properly complied with, void and unenforceable as a matter of statutory interpretation of s 151? (2) If not, under the common law, is such a contract illegal as to its formation? (3) If not, is such a contract illegal as to its performance?
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> I consider first whether every contract which constitutes financial assistance within s 151 is rendered void and unenforceable as a matter of statutory interpretation. In *Chitty on Contracts* [29th edn, 2004, Sweet & Maxwell] the following is stated [citations omitted]:
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>> Unenforceability by statute . . . arises where a statute itself on its true construction deprives one or both of the parties of their civil remedies under the contract in addition to, or instead of, imposing a penalty on them. If the statute does so, it is irrelevant whether the parties meant to break the law or not . . . Where the statute is silent as to the civil rights of the parties but penalises the making or performance of the contract, the courts consider whether the Act, on its true construction, is intended to avoid contracts of the class to which the particular contract belongs or whether it merely prohibits the doing of some particular act . . . It is important to note that where a contract or its performance is implicated with a breach of statute this does not entail that the contact is avoided. Where the Act does not expressly deprive the plaintiff of his civil remedies under the contract the appropriate question to ask is, whether, having regard to the Act and the evils against which it was intended to guard and the circumstances in which the contract was made and to be performed, it would in fact be against public policy to enforce it.
>>
>> If, on the true construction of the statute, 'the *contract* be rendered illegal, it can make no difference, in point of law, whether the statute which makes it so has in mind the protection of the revenue or any other object. The sole question is whether the statute *means to prohibit the contract*.' If, on the other hand the object of the statute is the protection of the public from possible injury or fraud, or is the promotion of some object of public policy the inference is that contracts made in contravention of its provisions are prohibited.
>
> Applying these principles, and having regard to the mischief to which s 151 is directed, I consider that contracts which are entered into in breach of s 151 are rendered illegal by that section. The section provides that it is 'not lawful' for a company to give financial assistance directly or indirectly for the purpose of the acquisition of its own shares. It seems to me to follow that contracts which are entered into in contravention of that section are illegal. In consequence, such contracts are void and unenforceable. Although the consequences on an innocent party may be harsh, it is well recognised that the courts will not lend their assistance to transactions which are rendered unlawful by statute.

Selangor United Rubber Estates Ltd v *Cradock (No 3)* [1968] 1 WLR 1555

In 1957 a company, with an issued capital of £90,000, which carried on business as a rubber company in the Malay States was without a business, having sold its rubber estates, but had liquid assets of about £235,800. B & T Ltd, acting for an undisclosed principal, C, made an offer for the company's stock. The offer was accepted by 79 per cent of the stockholders. The total amount payable for the stock and expenses was £195,000.

The first transaction

It was arranged by C that the company's account with a credit of £232,500 at N Bank should be transferred to a new account at a branch of D Bank where C had an account with a very small credit. At a meeting on 25 April 1958, two drafts for a total of £232,764 were received by D Bank for the company's new account. The company's board resolved to lend 232,500 to W T Ltd at 8 per cent interest and a cheque for £232,500 was drawn on the company's new account in favour of W T Ltd; W T Ltd lent that amount at 9 per cent interest to C and the cheque was indorsed by W T Ltd in favour of C and was paid into his account with D Bank, thus covering the payment of £195,000 to B & T Ltd. The bank made no inquiries before paying that cheque. The 79 per cent of the company's stock was in due course registered in one of D Bank's nominee companies as nominee for C. Both B & T Ltd and W T Ltd knew that C's purpose was to misapply the company's moneys to finance the purchasing of its stock. By 25 April 1958, the company's board of directors had been reshuffled and L and J had been appointed. Later in 1958 L resigned. Both L and J acted exactly as told by C and exercised no discretion or volition of their own. On 26 August 1958, the company's account was transferred to N S Bank where it was opened with a credit of about £700. The usual documents authorising directors to sign for the company's cheques drawn were sent.

The second transaction

On 26 January 1960, it was resolved at a meeting that the indebtedness of W T Ltd to the company and the indebtedness of two nominee companies of C should be taken over, as to £207,500 by C and as to £42,000 by H B Ltd; that a cheque for £207,500 in settlement of C's liability be paid into the company's account; and that bills for a total of £42,000 payable on future specified dates be drawn on H B Ltd in settlement of its liability. There was a further reshuffle of the board of directors. J and one A. J resigned, and B and S were appointed directors. At another meeting held on either 26 January or on 27 January 1960, S was appointed chairman and B secretary. It was resolved that the company should open an account with N S Bank, although it already had opened an account with that bank. The usual banking resolution was passed and a mandate valid for the opening of the account was signed by B and S authorising, *inter alia*, cheques drawn on the account to be signed by the chairman and secretary or any two directors. A cheque for £207,500 was drawn for B from the company's account in accordance with the mandate by S and B and B drew a cheque for the same amount on his own account in favour of C. At an interview with an official of the N S Bank in charge of the branch in the manager's absence it was explained that the cheques were being exchanged for 'internal accounting reasons' or 'internal book-keeping reasons' and all three cheques were debited and credited as directed. On 19 February 1960, C sent the company a cheque for £42,000 in place of the bills drawn on H B Ltd which had been refused. That cheque was part of another series of three cheques and on 25 February 1960, they were debited and credited to the three accounts in the same way as the three cheques for £207,500. The purpose of the second transaction was to finance the purchase by B from C of the stock in the company. S, though he knew the purpose, handed over the company's cheque, without security, to B, but it was not intended that the money paid to the company by the cheques should belong to it, the company serving a conduit pipe for the passage of that money.

On 12 August 1964, following investigations by its inspectors, the Board of Trade issued a writ in the name of the company pursuant to s 169(4) of the Companies Act 1948, claiming, *inter alia*, a declaration that the defendants C, L, J, B and S, being directors, B & T Ltd and W T Ltd, being other parties concerned with the transactions, and D Bank and N S Bank, being the company's bankers, were jointly and severally liable to replace moneys of the company which had been misapplied contrary to s 54 (1) of the Act of 1948. Ungoed-Thomas J noted:

> . . . does the principle prevent an action succeeding for breach of trust in doing what is illegal?
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> In ***Steen* v *Law*** directors of a company, incorporated in New South Wales, lent the company's funds which the directors had to give financial assistance to purchase the company's shares. The liquidator of the company claimed that there had thus been a breach of a New South Wales section, which, so far as material, was in the terms of s 54 of the Act of 1948; and that the directors had thereby committed a breach of their fiduciary duty to the company and should reimburse the company the sums so illegally applied. It was not contended that the directors were absolved from accounting by reason of the illegality of the loan by the company. Such illegality was clearly before the Privy Council and, if available against such a claim, provided a complete answer to it. Yet the point was neither taken by the defendants nor by the Privy Council; and it seems to me for the very good reason that the company was not relying for its claim on the unlawful loan and the relationship of creditor and debtor thereby created, but upon the misapplication by the directors of the company's moneys by way of the unlawful loan. That is the position with regard to the plaintiff's claim in our case. It was founding its claim, as in our case, not on a wrong done by it as a party to the unlawful loan, but as a wrong done to it by parties owing a fiduciary duty to it. The courts were being invited, as in our case, not to aid illegality but to condemn it. If this were not so, the courts would give redress to companies against directors for misapplication and breach of fiduciary duty which did not involve the company in illegality, but no redress if they were so serious as to involve the company in illegality.
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> I appreciate that, in the ordinary case of a claim by a beneficiary against a trustee for an illegal breach of trust, the beneficiary is not a party to the illegality; but that, when directors act for a company in an illegal transaction with a stranger, the company is itself a party to that transaction and therefore to the illegality. The company, therefore, could not rely on that transaction as 'the source of civil rights' and, therefore, for example, it could not successfully sue the stranger with regard to rights which it was claimed that the transaction conferred. If, however, property had passed under the illegal transaction, it is common ground that the right which the holding of that property conferred would be good against all the world, since the court would not assist the only party which had a better title, namely the party from whom it passed under the illegal transaction, to recover it. The right of the holder would be assisted by the courts, because it would be a right established by the holding, without having to rely on any right claimed to be conferred by the illegal transaction – and nonetheless because it was in pursuance of the illegal transaction, to which the holder was a party, that the holding in fact arose: (see particularly ***Singh* v *Ali***, and ***Chettiar* v *Chettiar***). In a claim based on an illegal breach of trust the claimant does not rely on a right conferred or created by that breach. On the very contrary, he relies on a right breached by the breach, as the very words 'breach of trust' indicate. It is only on the footing that there is a breach of trust that the defence of illegality becomes relevant. So it is assumed, for present purposes, that there is a breach of trust against the plaintiff by those who are directors and by those who are claimed to be constructive trustees. The constructive trustees are, it is true, parties with the plaintiff company itself to the transaction which is illegal. The plaintiff's claim, however, for breach of trust is not made by it as a party to that transaction, or in reliance on any right which that transaction is alleged to confer, but against the directors and constructive trustees for perpetrating that transaction and making the plaintiff company party to it in breach of trust owing to the plaintiff company. The breach of trust includes the making of the plaintiff a party to the illegal transaction. So it seems to me clear on analysis that the plaintiff is not precluded from relying on breach of trust by a party to an illegal transaction to which the plaintiff itself is a party, when the breach includes the making of the plaintiff a party to that very transaction. Those who proved to be constructive trustees, sharing the responsibility with the directors for the breach of trust, share the liability too.

> The result is that the plaintiff in this case would not, by reason of illegality, be prevented from being reimbursed money paid by it unlawfully under a transaction to which it is a party. But this does not mean that this would nullify the ordinary operation of illegality with regard to companies and parties outside the company, and not being or treated as being a trustee to it. But it would prevent such operation shielding those whose position or conduct makes them responsible as owing a fiduciary duty or as constructive trustee.

Held – although an illegal transaction in a contract or consensual arrangement, itself being forbidden, could not give rise to civil rights a claim could be based on an illegal breach of a right; that, therefore, as against the directors and constructive trustees, the company was not precluded from relying on breach of trust by an illegal transaction to which the company was itself a party when the breach included the making of the company a party to that very transaction; and that, accordingly, the fact that both the transactions in the present case were unlawful and avoided by s 54 of the Act of 1948 did not defeat the company's claims.

Management buy-outs and fair dealing by directors

Schemes of financial assistance given to directors to achieve a management buy-out would be caught and rendered illegal by Part X of the 2006 Act – loans, etc. to directors. Thus financial assistance for such a buy-out could only be given personally to management who were not at the time at board level. However, if they later became directors, the outstanding loan would not be illegal unless, for example, unpaid interest was added to the capital sum. However, if the directors of, say, A Ltd, or some of them, wished to buy out the major shareholders of A Ltd, a legal procedure would be for the acquiring directors to form another company, say B Ltd, and borrow money from a bank in B Ltd's name, letting A Ltd give a security over its assets to the bank to secure the loan to B Ltd of which the acquiring directors would form the board. The loan would be used to buy the shares in A Ltd thus making it a wholly owned subsidiary of B Ltd. Although A Ltd would have given financial assistance for the purchase of its own shares, this would be within the law because the assistance would not be the 'principal purpose' but part of a management buy-out.

Financial assistance: auditors' duty

In ***Coulthard* v *Neville Russell (A Firm)*** [1998] 1 BCLC 143, the Court of Appeal decided that as a matter of principle auditors have a duty of care, not only to the company as client, but also to its directors to advise them that a transaction which the company and its directors intend to carry out might be a breach of the financial provisions of the Companies Act 2006. It will be appreciated that the giving of unlawful financial assistance may affect the contracts concerned with it at civil law and can result in criminal proceedings under which the company may be required to pay an unlimited fine, and its officers, if convicted, may receive a custodial sentence of up to two years and/or an unlimited fine. Because auditors are often asked to advise, and do advise, directors on the treatment of items in the accounts and their likely attitude as auditors to particular future transactions, it may well be that the duty to give advice on the statutory legal position could frequently arise. The decision seems to widen the scope of potential liability of auditors for negligence. The allegations accepted as a basis for a duty of care in this case seem to depend on an omission, i.e. the failure to advise that a particular transaction which the directors tell the auditors they intend to do may be illegal.

Essay questions

1 Soapstone Ltd has agreed with a merchant bank that the bank is to take a £50,000 equity stake in the company in the form of ordinary shares which will be redeemable in 2011 or earlier at the option of Soapstone Ltd.

Advise the directors as to the funds which can be used for the redemption, and as to the statutory procedure for the issue of redeemable shares. (*Napier University*)

2 Microchip is a public limited company. Allan and Bill are directors of the company who own 85 per cent of its equity shares between them. In addition, Allan also owns certain debentures issued by the company. The remaining 15 per cent of the equity shares is owned by Charles. Allan now wishes to dispose of his shares and debentures so as to enable him to retire to the south of France. Bill and Charles are concerned that the shares and debentures should not fall into the hands of strangers who might disrupt the smooth running of the company. They consult their accountant who devises the following scheme:

(a) Microchip uses reserves in the profit and loss account to purchase the shares and raise the necessary funds from its bank to purchase the debentures; or

(b) Microchip guarantees a private loan which Bill will arrange with his bank so as to purchase the shares and debentures as a gift to his wife; or

(c) Charles obtains a private loan, guaranteed by Microchip, to purchase Allan's shares and debentures.

Advise Microchip plc as to the legal validity of each of the proposed schemes. Would your answers be different if Microchip were a private company? (*University of Plymouth*)

3 Identify and explain the three specific circumstances envisaged by the Companies Act 2006 for a reduction of share capital. (*The Institute of Chartered Accountants in England and Wales*)

4 Assume you are the management accountant reporting to the finance director of a public listed company. The finance director has recently undertaken a financial review as part of the company's strategic review process. In his report he has suggested that the company has more funds than are necessary to support its planned growth and that capital should be reduced.

You are required to write a report for the finance director explaining the methods which may be adopted to reduce the capital of the company.

(*The Chartered Institute of Management Accountants*)

5 (a) State the exceptions to the general rule that a public company must not give financial assistance to any person for the purpose of the acquisition of its own shares.

(b) Milk Bottles Ltd is a profitable small family company whose principal activity is the retail distribution of milk. The elderly directors appoint Kevin, a younger man, to the board. The articles of association require each director to hold 1,000 £1 qualification shares and allow a director two months from the date of his appointment to acquire his qualification shares. Kevin has not got the money to enable him to do this and the company is willing to lend him the necessary finance.

Advise:

(i) the directors as to the procedures they should observe to effect the loan;
(ii) Steven, a director who disapproves of the arrangement, of any action he may take.

(*The Association of Chartered Certified Accountants*)

6 Section 33 of the Companies Act 2006 provides that the company's constitution shall, when registered, bind the company and the members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and articles.

Explain the effect of this section on the relationships between shareholders and their company, persons acting in another capacity than that of shareholders and the company and between the shareholders themselves. Illustrate your answer with decided cases.

(*Glasgow Caledonian University*)

7 (a) The general legal principle is that a company has a separate legal existence from that of its members. In what circumstances does that general principle not apply? Give examples of such situations.

(b) Walter is employed as a managing director by Clipse Ltd whose main object is to retail office equipment. His contract of employment contains a clause which states that in the event of his leaving the employment of Clipse Ltd he will not solicit its customers for a period of two years. He resigns his employment and together with his wife Jean forms a new company, Desks Ltd, whose main object is also retailing office equipment. Bill is a salesman employed by Desks Ltd. He is given customer lists by Walter and immediately begins soliciting Clipse Ltd's customers.

In order to raise cash for his new business, Walter enters into a contract to sell his house to Wilf for £450,000. Bill, who has always admired the house, approaches Walter and makes him an offer of £460,000. Walter transfers ownership of the house to Desks Ltd, and on behalf of the company enters into negotiations to sell the house to Bill.

Advise Clipse Ltd and Wilf on any action they can take.

(*The Association of Chartered Certified Accountants*)

Test your knowledge

Four alternative answers are given. Select ONE only. Circle the answer which you consider to be correct. Check your answers by referring back to the information given in the chapter and against the answers at the back of the book.

1 Jock wants Trent Ltd to give a security over its assets to the Derwent bank so that the bank may lend Jock money to buy shares in Trent Ltd. The position regarding this proposal is:

A It is lawful if the court approves.
B It is lawful if approved by an ordinary resolution in general meeting.
C It is lawful if approved by a special resolution in general meeting or a written resolution.
D It is always unlawful for a company to give financial assistance for the purchase of its shares.

2 The directors of Humber Plc are intending that the company should purchase some of its own shares partly from capital. Amongst other things they must make a statutory declaration containing a statement that in their opinion the company will be able to carry on business as a going concern and will be able to pay its debts as they fall due during a stated period not exceeding:

A Twelve months
B Six months
C Eighteen months
D Two years

3 The directors of Tyne Ltd intend a purchase by the company of its own shares from John, a member, but partly out of Tyne's capital. They have made an appropriate statutory declaration and have also called an extraordinary general meeting of the members. Which of the following resolutions must be passed to approve the proposal?

A An ordinary resolution.
B A special resolution.
C An extraordinary resolution.
D An ordinary resolution following special notice.

4 What is the maximum permitted period between the passing of a resolution sanctioning a purchase of own shares partly from capital and the date of payment?

A Fifteen days
B One week
C Five weeks
D Seven weeks

5 The assets of Derwent plc are less than one-half of its called-up share capital. The directors must call an extraordinary meeting of the members to be held not later than 56 days from the date:

A On which the auditor informed the directors in writing of the capital loss.
B On which all the directors became aware of the capital loss.
C On which a director became aware of the capital loss.
D Of the deposit of a requisition by 15 per cent of the voting members.

Answers to test your knowledge questions appear on p. 616.

Suggested further reading

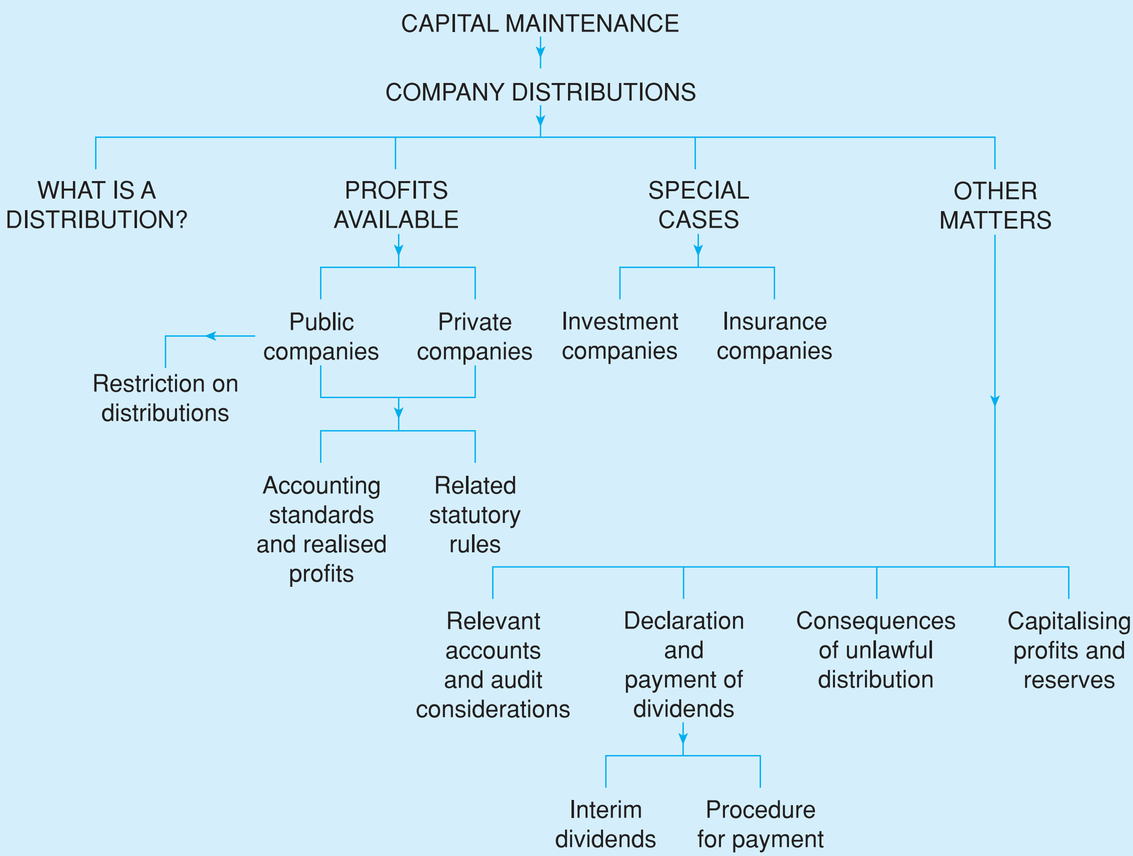
Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?', (2000) 63 MLR, 355

Armour, 'Legal Capital: An Outdated Concept', (2006) 7 European Business Organisation Law Review 5

Daehnert, 'The Minimum Capital Requirement – An Anachronism under Conservation, Parts 1 and 2, [2009] 30 Co Law 3 and 34

Worthington, 'Shares and Shareholders: Property, Power and Entitlement, Parts 1 and 2', (2001) 22 Co Law 258 and 307

9 Capital maintenance – company distributions



The matter of company distributions is a specific and rather special aspect of capital maintenance. The relevant rules are considered below together with the rules relating to the declaration and payment of dividends.

Profits available for distribution – generally

In earlier times when the narrower term *dividend* was used rather than the current expression *distributions*, it was said that 'dividends may not be paid out of capital'. This meant simply that share capital which the company had received from its shareholders could not be used to pay dividends to them. As we have said before, the creditors take the risk that the company's capital will be lost by business failure but they are protected by the law against it being paid back to the shareholders. An alternative way of expressing the rule is that 'dividends may only be paid out of profits'.

A continuing problem in protecting the creditors' buffer in this area of company law has been the identification of that portion of a company's resources which can legitimately be regarded as capital and, therefore, not distributable and that portion which can legitimately be regarded as profit and consequently distributable.

The Companies Act 1980 made radical changes in regard to company distributions and these rules, which are now to be found in Part 23 of the Companies Act 2006, are set out below.

What is a distribution?

According to s 829 of the Companies Act 2006, it is every description of distribution of a company's assets (not only a dividend) to members of the company, whether in cash or otherwise, except distributions made by way of (a) an issue of shares as fully or partly paid bonus shares; (b) the reduction of share capital: (i) by extinguishing or reducing the liability of any of the members on any of the company's shares in respect of share capital not paid up; or (ii) by repaying paid-up share capital; (c) the redemption or purchase of any of the company's own shares out of capital (including the proceeds of any fresh issue of shares) or out of unrealised profits in accordance with Chapters 3, 4 or 5 of Part 18 of the Companies Act 2006; (d) a distribution of assets to members of the company on its winding up.

Thus, if Boxo Ltd, a television and video hire company, run by, say, five family shareholders, decided that instead of paying shareholders a cash dividend it would instead give each shareholder free equipment, that would be a distribution and subject to the statutory rules discussed below.

Since the provisions are concerned with payments of *dividend* payments by way of *deferred remuneration* to directors, even though there are no realised profits available, they are not caught by the distribution rules (see ***MacPherson* v *European Strategic Bureau Ltd*** [2000] 2 BCLC 683). However, such payments would be void and recoverable by the company if it was insolvent. Then the creditors' interests would be paramount.

Profits available – public and private companies

The basic rule outlined in s 830(2) of the Companies Act 2006 is that a company's profits available for distribution are: (a) its accumulated realised profits (both revenue and capital) not previously distributed or capitalised (as by being applied in financing a bonus issue or the purchase or redemption of the company's shares with a transfer to a capital redemption reserve), LESS (b) its accumulated realised losses (both revenue and capital) not written off in a reduction or reorganisation of capital. It is also worth noting the wording of s 830(1) which states that a company may only make a distribution out of profits available for the purpose.

From the above provisions it follows that:

1 Unrealised profits, either revenue or capital, are no longer distributable.
2 A realised capital loss following, for example, the actual sale of an asset at a loss will reduce the profit available for distribution. The 2006 Act requires the making good of unrealised capital losses following, for example, the downward revaluation of an asset retained by the company, but only for public companies (see below).

   The depreciation of fixed assets is required and realised losses to be taken into account when calculating the sum available for dividend include amounts written off or retained for depreciation. This ensures that dividends will be restricted to allow for depreciation, subject to what is said below.
3 The use of the word 'accumulated' is important. It means that the position in the current year cannot be regarded in isolation. The profit and loss account is a continuous account. Thus, if Boxo Ltd makes a trading loss of £1,000 in year 1 and £2,000 in year 2, but a trading profit of £1,000 in year 3, it must make a profit in excess of £2,000 in year 4 before any dividend can be paid, unless the company applies to the court for a reduction of capital, so cancelling the losses.
4 Undistributed profits of previous years cannot be brought forward and distributed without taking into account a revenue loss on the current year's trading.
5 An unrealised capital profit cannot be applied in writing off a realised revenue loss.

The provisions also introduce other concepts which are set out below. Insofar as these relate to realised profits reference should be made to the fourth Schedule which states, in effect, that references in the Schedule to realised profits are to such profits as fall to be treated as realised profits, in accordance with principles generally accepted with respect to the determination for accounting purposes of realised profits, at the time when the relevant accounts are prepared.

This implies that it is for the accounting profession to specify in more detail the meaning of realised profits and that the term may be amended from time to time so as to encompass changes in accounting practice.

Restriction on distributions by public companies

Furthermore, with respect to public companies, s 831 of the Act states that a public company may only make a distribution if the amount of its net assets (i.e. the aggregate of the company's assets less the aggregate of its liabilities) is not less than the aggregate of its called-up share capital and undistributable reserves, and if the distribution does not reduce the amount of those assets to less than that aggregate. This means in effect that a plc must deduct any net

		Company A		Company B
		£		£
Share capital		50,000		50,000
Surplus or deficit on revaluation of fixed assets		4,000		(4,000)
Realised profits	7,000		7,000	
Realised losses	(2,000)	*5,000*	(2,000)	5,000
Total share capital and reserves/net assets	=	59,000		51,000
Distributable profit				
(*a*) if private company		5,000		5,000 (no capital maintenance rule)
(*b*) if public company		5,000		1,000 (capital maintenance rule applies)

Figure 9.1 **The capital maintenance rule**

unrealised losses from net realised profits before making a distribution. A private company need not do so.

Section 831(3) goes on to define the term 'liabilities' as including where the relevant accounts are Companies Act accounts, provisions of a kind specified for the purposes of this subsection by regulations under s 396; and where the relevant accounts are IAS accounts, provisions of any kind.

Furthermore, s 832(4) defines the term 'undistributable reserves' as a company's share premium account; capital redemption reserve; the amount by which its accumulated, unrealised profits (so far as not previously utilised by capitalisation) exceed its accumulated, unrealised losses (so far as not previously written off in a reduction or reorganisation of capital duly made); and any other reserve that the company is prohibited from distributing: (i) by any enactment (other than one contained in this Part); or (ii) by its articles. Section 831(5) goes on to provide that a public company must not include any uncalled share capital as an asset in any accounts relevant for purposes of this section.

Although the above rule applies only to plcs, it should be noted that none of the reserves listed above is distributable by private companies.

An illustration of the capital maintenance rule appears in Figure 9.1.

Realised profits and accounting standards

There are several possible meanings of the expression 'realised' starting with the obvious one of realised in cash. The conclusion reached following research by the accounting bodies was that the preferable approach would be to treat an item as realised if its occurrence can be established from sufficiently reliable measurements. The profit and loss account should be confined to *legally* distributable profits. The treatment of individual items should follow the guidance set out in the relevant Statements of Standard Accounting Practice (SSAPs) and, more recently, Financial Reporting Standards (FRSs), issued by the Accounting Standards Board.

These are not considered further here because they are part of accounting rather than legal practice and should be studied in the accounting context. As a legal point, however, it should be noted that it was stated in ***Lloyd Cheyham & Co*** v ***Littlejohn & Co*** [1987] BCLC 303 that 'SSAPs are very strong evidence as to what is the proper standard which should be adopted and unless there is some justification a departure [. . .] will be regarded as constituting a breach of duty'.

While the following of appropriate standards will continue to be a vital part of accountancy practice it will be possible for a court to find liability in negligence even though a relevant standard has been followed if the implication of a decision of the House of Lords in ***Bolitho*** v ***City and Hackney Health Authority*** [1997] 4 All ER 771 is taken to its logical conclusion. The Law Lords qualified the long-established principle laid down in ***Bolam*** v ***Friern Hospital Management Committee*** [1957] 2 All ER 118 that so long as medical practitioners relied on 'a responsible body of professional opinion' they would not be liable in negligence. The court was not bound, their Lordships said in ***Bolitho***, to hold that a defendant doctor would escape liability for negligent treatment or diagnosis just because he leads evidence from a number of medical experts who are generally of the opinion that the defendant's treatment or diagnosis accorded with sound medical practice. The court has to be satisfied that the exponents of the body of opinion relied upon can demonstrate that such an opinion has a logical basis.

Although the ***Bolitho*** case is a medical one, it is likely to be given general application. It seems now that it will not necessarily be enough to meet an allegation of negligence with the response that the actions complained of are accepted and practised by many others. The court will wish to be satisfied that the practice stands up to logical scrutiny. Canadian courts have already pronounced on the position regarding accountants: the Court of Appeal of British Columbia in ***Kripps*** v ***Touche Ross*** (1992) 94 DLR (4th) 284 held against Touche on the ground 'that the accountants had known that a simple application of [a Canadian accounting standard] would omit material information'.

While ***Bolitho*** is an important case, it is in practice unlikely that the courts will often find that existing accounting standards are illogical, although they have now acquired the right to do so in appropriate circumstances. The decision is perhaps not too surprising. Professional persons cannot really expect to be judges in their own cause.

Related statutory rules

The relevant statutory provisions, running alongside accounting practice, are summarised below.

1 An unrealised profit cannot be applied in paying up debentures or any amounts outstanding on partly paid shares.
2 As we have seen, provisions for depreciation (and contingencies) are to be regarded as realised losses when considering profits available for distribution. In addition, a deficit on the revaluation of an asset gives rise to a provision which must be treated as a realised loss except in two situations when the provision may be treated as an unrealised loss – (a) where the deficit offsets an unrealised profit previously recorded on the same asset;

(b) where the deficit arises on a revaluation of all the fixed assets. This applies even though goodwill is not revalued, notwithstanding that goodwill is treated by the formats of the 2006 Act, which deal with the way in which company accounts are to look, as a fixed asset.

The revaluation does not necessitate the changing of the amounts of every fixed asset, but that every such asset be considered for revaluation by the directors. They must be satisfied that those assets whose values have not been changed have an aggregate value not less than their aggregate amount as stated in the financial statements.

The above will not apply unless the notes to the relevant accounts state:

(a) that the directors have considered the value at any time of any fixed assets of the company without actually revaluing those assets;
(b) that they are satisfied that the aggregate value of those assets at the time in question is, or was, not less than the aggregate amount at which they are, or were for the time being, stated in the company's financial statements;
(c) that the relevant items affected are accordingly stated in the relevant accounts on the basis that a revaluation of the company's fixed assets which included the assets in question took place at that time.

It will be noted that the 'aggregate' approach enables losses on some assets to be compensated for by increases in the value of others.

3 Where a fixed asset is revalued upwards and subsequently depreciated, only that part of the depreciation applicable to the value of the asset before its revaluation is treated as reducing realised profits. The excess may be added back to distributable profits.

The entries in accounting terms are set out in Figure 9.2.

4 Development costs, e.g. the costs of developing a saleable company product before any revenue is received from its sale or use, must in general be treated as a realised loss. If they are shown as an asset, i.e. capitalised, they are to be treated as a realised loss, except insofar as the development costs represent an unrealised profit made on a revaluation of those costs. The basic rule of realised loss does not apply either if the directors justify, in the light

	Dr	Cr
	£	£
Fixed asset at cost (2002)	2,000	
Revaluation (end 2002)	1,200	
Revalued amount before depreciation	3,200	
Revaluation reserve		
Fixed asset revaluation		
realised		1,200
unrealised		(120)
		1,080
Provision for depreciation		
Charge to P and L Account for 2002		
(10 per cent of revalued figure at end 2002)		320
(Excess depreciation over 2001 = £120)		

Figure 9.2 **Realised profits – provisions for depreciation**

of special circumstances, that the amount carried forward shall not be treated as a realised loss. For example, the directors may feel that future benefits in terms of revenue from the product can be reasonably anticipated in the near future and may wish to set off the expenditure on development against future revenue from its sale or use rather than treat it as a realised loss in a particular year. The grounds of justification must be included in the notes to the accounts on capitalised development costs as required by the fourth Schedule.

Special cases

Investment and insurance companies are subject to different rules contained in ss 832–835. Basically, the 2006 Act gives an investment company (i.e. a public listed company whose business consists of investing its funds mainly in securities with the object of spreading investment risk and giving its members the benefits of the management of its funds), an option when making a distribution of using either the capital maintenance rule or an asset/liability ratio test under which it can make a distribution *but only out of its accumulated realised revenue profits less accumulated revenue losses* so long as this does not reduce the amount of its assets to less than one and a half times the aggregate of its liabilities immediately after the proposed distribution.

An amount properly transferred to the profit and loss account of an insurance company from a surplus on its long-term business, e.g. life assurance, shall be considered as realised profit and available for distribution provided it is supported by actuarial investigation showing a surplus in the sense of assets over liabilities attributable to the long-term business.

Relevant accounts

The Companies Act 2006 requires companies to decide the question whether a distribution can be made and the amount of it by reference to 'relevant accounts'. The relevant accounts, which must have been prepared to give a true and fair view, will most usually be the last annual accounts. The accounts must have been laid before the company in general meeting, though a private company may elect to dispense with this requirement (see Chapter 23). In any case the accounts must have been prepared in accordance with the provisions of the Companies Act, or have been so prepared subject only to matters which are not material for the purpose of determining the legality of a proposed distribution.

See p. 504

Audit considerations

The auditors of a company must have made an unqualified report on the accounts. If the report is qualified, then the auditors must state in writing whether, in their opinion, the substance of the qualification is material for the purpose of determining the legality of the proposed distribution. A copy of any statement by the auditors relating to the qualification must have been laid before the company in general meeting, or in the case of a private company, which is not laying the accounts before a general meeting, circulated to the members.

In the case of a holding company, the latest annual accounts would normally be group accounts and reported profit will have been determined by consolidation. If the consolidated accounts are qualified, it may be necessary for the auditors to state whether or not the qualification is material to the calculation of distributable profits of the holding company. From a legal point of view, the distributable profits are the realised profits of the holding company. In ***Re Precision Dippings Ltd*** [1985] 3 WLR 812 it was held that compliance with these provisions was not a mere procedural matter.

In this case the company paid a dividend of £60,000 to its holding company. This payment exhausted the subsidiary company's cash resources, and some months later it went into voluntary liquidation. The liquidator sought recovery of the payment plus interest since it had contravened the Companies Act and so was *ultra vires*.

For the year in question the auditors' report contained a qualification as to the basis of valuing work in progress. The auditors had not made the statement required by the 1985 Companies Act and the directors were unaware that it was required.

After the company had gone into liquidation, the auditors issued a statement that, in their opinion, the basis of the valuation of work in progress referred to was not material for the purpose of determining whether the dividend of £60,000 would have been in contravention of the Act. This statement was subsequently accepted by a resolution of the shareholders.

The court *held* that the distribution rules are a major protection for creditors, and the requirement for an auditor's written statement when the audit report is qualified is an important part of that protection. This statement has to be available before the distribution is made. The payment of the dividend was *ultra vires* and the holding company held the £60,000 as constructive trustee for the subsidiary.

The resolution of the shareholders could not ratify or confirm the dividend payment. The shareholders could not dispense with or waive the legal requirements.

The above provisions regarding the functions of the auditor do not apply to companies which have dispensed with the audit requirement. For these companies there is therefore no audit or reporting requirement for the last accounts on distribution of profit.

Declaration and payment of dividends

There is no absolute right to a dividend. The question of declaration of dividends is usually dealt with by the articles and the entitlements, as between shareholders, are determined by the class rights attached to the shares. As noted in the case of ***Precision Dippings Ltd*** v ***Precision Dippings Marketing Ltd*** [1986] Ch 447, the statutory procedure prescribed for the declaration of a dividend is mandatory and a subsequent resolution of the shareholders cannot rectify matters.

Where the articles follow the pattern of *Table A*, the members can declare dividends by ordinary or written resolution but cannot declare a dividend higher than that recommended by the directors, and if the directors do not recommend payment of dividend, the members cannot declare one either on the preference or ordinary shares. Under such a provision the members in general meeting can reduce the dividend recommended by the directors. As regards the dividend payable in a particular year, the matter is usually already decided because the dividend has been paid before the general meeting is held. However, the members could reduce the dividend recommended and paid which would involve adjustments in the accounts for the following year.