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.

The new model articles for both public (Art 69) and private companies (Art 30) limited by shares require a recommendation from the board of directors for a dividend to be declared together with approval from the shareholders. Once again, the shareholders cannot approve a level of dividend above that recommended by the directors of the company.

Dividend payments have in the past been put to the members for approval at the annual general meeting but where a private company has elected not to hold annual general meetings, approval to the payment of dividend can be sought from the members at any time to suit the administrative convenience of the company in terms of the date on which a dividend payment is to be made but member approval by written resolution is required.

Table A provides that all dividends shall be declared and paid according to the amounts paid up on the shares. Under such an article, no amount credited as paid in respect of calls in advance could be counted as paid for this purpose. Where the company's articles exclude *Table A* and yet do not provide for the method of payment of dividend, dividends are paid on the nominal value of the shares.

A dividend must be paid in proportion to the shares held and at a uniform rate on all shares of the same class. It is not possible, therefore, for the holders of a majority of the shares to pass a resolution to the effect that a larger dividend (or a smaller one) shall be paid on their shares than on those of other members.

Thus if a company has two shareholders, A and B, who hold 60 per cent and 40 per cent respectively of the issued and paid-up ordinary share capital and they both agree that they should be paid the same amount of dividend in regard to the last year's accounts, this is illegal unless the shareholdings are amended to a 50/50 proportion. Thus, a total dividend of £20,000 cannot be split as to £10,000 each. The split must be £12,000/£8,000 unless the shareholding is changed.

Unless the articles otherwise provide, dividends are payable in cash, but *Table A* provides that the company may distribute specific assets in whole or in part satisfaction. *Table A* also provides that payment may be made by cheque sent through the post to the registered address of the holder. In the case of joint holders, it is sent to the one whose name appears first on the register of members, or alternatively as the joint holders may direct *in writing*. Any one of two or more joint holders may give an effectual receipt.

Table A further provides that no dividend shall bear interest against the company, unless otherwise provided by the rights attached to the shares.

Dividends, when declared, are in the nature of a specialty debt and can be sued for up to 12 years from the date of declaration.

Interim dividends

When the directors can see that the company is going to make a sufficient profit by the end of the financial year, they may declare a dividend part way through the year which is in the nature of a part payment of the dividend for the year as a whole. At the end of the year a final dividend is declared in respect of the balance. *Table A* provides that the directors may from time to time pay to the members such interim dividends as appear to the directors to be justified by the distributable profits of the company. Under *Table A* an interim dividend does not require the approval of a general meeting of the members, and is not in the nature of a debt due from the company. Thus, if it is not paid, it cannot be sued for, and there is nothing to prevent the directors subsequently rescinding or varying the dividend (***Lagunas Nitrate Co* v *Schroeder*** (1901) 85 LT 22).

Where the directors propose to pay an interim dividend, reference may have to be made to interim accounts (s 836), which in the case of a public company must be such 'as are necessary to enable a reasonable judgment to be made', i.e. accounts complying with the 2006 Act (true and fair view) and signed by a director.

In this regard, s 838 states that interim accounts must be accounts that enable a reasonable judgment to be made as to the amounts of the items mentioned in s 836(1). Where interim accounts are prepared for a proposed distribution by a public company, the following requirements apply. Section 838(3) provides that the accounts must have been properly prepared, or have been so prepared subject to matters that are not material for determining whether the distribution would contravene Part 23 of the 2006 Act.

In this respect, 'properly prepared' means prepared in accordance with ss 395 to 397 (requirements for company individual accounts), applying those requirements with such modifications as are necessary because the accounts are prepared otherwise than in respect of an accounting reference period (s 838(4)). Furthermore, s 838(5) states that the balance sheet comprised in the accounts must have been signed in accordance with s 414. Finally, a copy of the accounts must have been delivered to the registrar.

It is worth noting that the articles of a company normally provide for interim dividends to be paid solely on the authority of the board of directors, rather than requiring the approval of the shareholders in addition. This approach is replicated in the model articles under the 2006 Act in the form of Art 69 (public companies) and Art 30 (private companies).

Procedure for payment of dividend

The company may close its register for a short time before payment is made in order that the register shall remain static while the procedure for payment is carried out. *Dividend warrants* are prepared in favour of those persons whose names appear on the register, the dividend being declared according to the recommendation of the directors. The warrants are posted to the shareholders as soon as possible after the dividend is declared. However, companies encourage the use of a dividend mandate system under which the payment is direct into the shareholder's bank account.

In the case of *share warrants*, the company will advertise that the dividend is payable in exchange for a coupon bearing a certain number, these coupons being attached to the share warrant. A dividend warrant is then made out in the name of the present holder of the share warrant.

It is current practice not to close registers but to declare a dividend payable to shareholders registered as at close of business on a given date (the striking date). It should be noted that companies are not concerned with equities when paying dividends. The registered shareholder (or the first named of joint holders) on the striking date or the first day on which the register is closed is the person to whom the dividend is paid. If such a person has recently sold his holding *cum* (with) dividend, the buyer's broker will claim it through the seller's broker. If the sale was *ex* (without) dividend, the seller keeps it and no claim arises. The purchase price of the share will take into account the *cum* or *ex* dividend element.

Many companies include a power in their articles to forfeit unclaimed dividends after a reasonable period. However, in the case of quoted companies Stock Exchange regulations insist that such a power shall not be exercised until 12 years or more have passed since the dividend was declared. *Table A* provides that any dividend which has remained unclaimed for 12 years from the date when it became due for payment shall, if the directors so resolve, be forfeited and cease to remain owing by the company.

In the case of public listed companies, the requirements of the listing agreement as appearing in the Listing Rules issued by the Financial Services Authority, which deals with the listing of companies on the London Stock Exchange, would have to be considered. This specialist area is considered in outline in Chapter 10.

See p. 212

Directors failing to declare dividends

It may well be that in a private company the directors are happy to take their salaries from the company and refuse to declare dividends. Members who are not on the board may seek advice as to the availability of remedies in this situation. Where the company has articles similar to those of *Table A* nothing can be done under the constitution. Members who find themselves in this situation are usually minority shareholders and so cannot change the articles. Regulation 102 allows the members by ordinary resolution to declare dividends not exceeding the amount recommended by the directors. So if the directors' 'recommendation' is nil that is it.

However, a failure to pay a dividend may, in certain instances, amount to grounds for the court ordering the winding-up of a company on the 'just and equitable' ground, if it has pursued a restrictive dividend policy and prevented shareholders receiving a return on their investments which they are reasonably entitled to expect (***Re a Company*** (1988) 4 BCLC 506). The court also indicated in ***Re Sam Weller & Sons Ltd*** [1990] Ch 682 that a restrictive dividend policy may justify relief being granted by the courts under s 994 of the Companies Act 2006. Under s 994 (see Chapter 16) a minority could ask the court for a declaration that they have been and are being unfairly prejudiced by the conduct of the board. Any order made by the court would normally be a requirement for the majority or the company to purchase the shares of the minority at a price to be determined usually by the company's auditors or advising accountants. The court is unlikely to declare and continue to declare dividends. As a minority such members would not have sufficient power to remove the board and so s 994 is the only real way of getting out of the company with their capital.

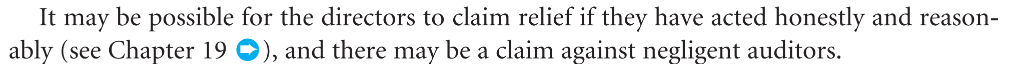
See p. 312

Consequences of unlawful distribution

Section 847(2) provides that if a member of a company knows or has reasonable grounds to believe at the time a distribution was made to him that it contravened Part 23 of the 2006 Act he is liable to repay it (or the illegal part) to the company. Section 847 does not deal with the civil liability of the directors who made the improper distribution. However, since they have misapplied the company's property they are in breach of their fiduciary duty to the company and therefore are jointly and severally liable to the company to replace the dividend paid. This was decided in ***Flitcroft's Case*** (1882) 21 Ch D 519 and means that each director can be called upon to repay the whole amount, and if he does he has a right of contribution against the others. Thus, there are three directors – A, B and C. The dividend wrongly paid is £3,000. A is called upon to pay and does. He may then recover by a claim at law if necessary £1,000 from B and £1,000 from C. Section 847(3) makes it clear that the liability of the members at common law is preserved, and according to the decision in ***Moxham* v *Grant*** [1900] 1 QB 88 directors who have repaid the dividend to the company have a right of *indemnity* against each

shareholder who received the dividend to the extent of the dividend received whether the shareholder concerned *knew or not* that it was paid out of capital.

See p. 378



It may be possible for the directors to claim relief if they have acted honestly and reasonably (see Chapter 19), and there may be a claim against negligent auditors.

Allied Carpets Group plc* v *Nethercott [2001] BCC 81

In this case the High Court ruled that a former managing director who had received dividends that he knew were paid on the basis of inadequate accounts held the dividends on a constructive trust for the company and he was required to repay them to the company. The accounts deliberately overstated both sales and profits by the inclusion of uncompleted transactions. The accounts failed therefore to comply with ss 270 and 271 of the CA 1985 there being also no auditor's report or statement as required by s 271 (s 837 of the CA 2006).

Comment

(i) In this connection, the High Court has also ruled that the directors of a plc who had authorised the payment of dividends other than out of distributable profits were personally liable to repay them to the company, regardless of whether they themselves were the recipients of the dividend (see ***Bairstow* v *Queens Moat Houses plc***, High Court [2000] 1 BCLC 549). The amounts were not inconsiderable, being £27.7 million of dividend and £14 million in interest.

(ii) In the matter of ***Marini Ltd (liquidator of Marini Ltd)* v *Dickinson*** [2003] EWHC 334 (Ch) the High Court was asked to excuse directors, who had paid dividends that exceeded available profits, under s 727 CA 1985 because they had acted honestly and reasonably on accountants' advice. The court agreed that they had so acted but would not exercise its discretion to excuse because the directors had themselves received the benefit of the dividend and could not be left with what was a default benefit.

(iii) In ***Re Loquitur Ltd, IRC* v *Richmond*** [2003] STC 1394 the High Court ruled that the directors of a company were liable to repay to the company certain dividends declared on the basis of improperly prepared accounts which they had drawn up. The accounts did not make provision for a potential corporation tax liability if a rollover relief scheme failed, which it did. The directors' plea to be excused because they had been assisted by what the court called 'a raft of advisers' in terms of an appropriate scheme failed because they used an alternative scheme not referred back to the advisers before declaring the dividend.

In the situation of an insolvent company, directors and shareholders may be required to pay back certain dividends that have been made in contravention of s 630 of the Companies Act 2006.

It's a Wrap (UK) Ltd (In Liquidation)* v *Gula [2006] BCLC 634

The appellant company (W) appealed against the decision ((2005) EWHC 2015 (Ch)) that the respondents (G) were not liable to repay dividends which they had paid to themselves when the company had had no profits out of which it could lawfully have paid the dividends. In the relevant years W had made trading losses. Despite the fact that there were no profits out of which to pay dividends, G, as the shareholders and directors of W, had caused W to pay them substantial dividends in contravention of the Companies Act 1985 s 263 (now s 630 CA 2006). W brought proceedings for return of the dividends relying on s 277(1) of the 1985 Act (now s 847 CA 2006) which implemented the Second Council Directive 77/91 Art 16 and provided a statutory remedy against

a shareholder for recovery of an unlawful distribution paid to him if he knew or had reasonable grounds to believe that it had been made in contravention of the Act. G's case was that the dividends described as such in the company's accounts had been paid as salary and shown as dividends as a tax efficient method of drawing the salaries, which was normal practice for small businesses and had been done on the advice of an accountant. The judge held that s 277(1) required G to know that they were contravening the Act when they paid the dividends and that since they were ignorant of its provisions they were not liable to repay the dividends. G submitted that a shareholder had to have knowledge of the requirement of the Act that the distribution contravened.

Held – allowing the appeal – that s 277(1) had to be interpreted in accordance with Art 16 of the Directive which provided that any distribution made contrary to Art 15 had to be returned by shareholders who received it if the company proved that the shareholders knew of the irregularity of the distribution or could not have been unaware of it. A person was taken to know the content of Community law as soon as it was published in the Official Journal, ***Friedrich Binder GmbH & Co KG*** v ***Hauptzollamt Bad Reichenhall*** (161/88) [1989] ECR 2415 applied. Accordingly the right approach to the interpretation of Art 16 was to proceed on the basis that when implemented the general presumption that ignorance of the law was no defence would apply unless on the true interpretation of the Directive it was excluded. On its true interpretation Art 16 meant that a shareholder was liable to return a distribution if he knew or could not have been unaware that it was paid in circumstances which amounted to a contravention of the restrictions on distributions in the Directive, whether or not he knew of those restrictions. The expression 'the irregularity' of the distributions referred to the fact that they had been made contrary to Art 15. It followed that all the company had to show was that the shareholders knew the facts constituting the contravention. In the instant case since G had been aware that the company had no profits they knew that the distributions had been made in contravention of the Act for the purposes of s 277(1).

Capitalising profits

The company may, as an alternative to paying a cash dividend, capitalise its profits (see s 853(3)). This may be achieved by the allotment of fully paid-up bonus shares (or scrip issue, or capitalisation issue as it is sometimes called) by transferring to the capital account undistributed profit equal to the nominal value of the shares issued.

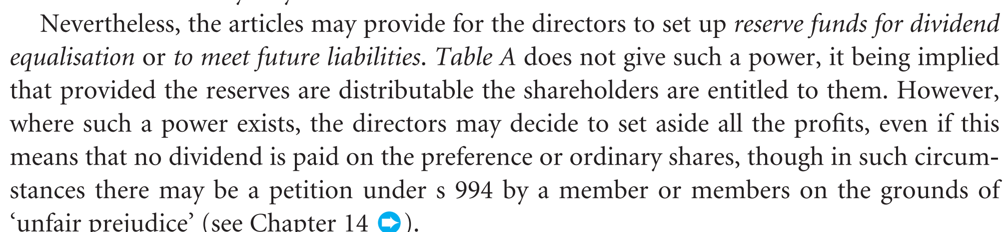
Profits, including unrealised profits, cannot be capitalised unless the articles so provide because, as we have already seen, in the absence of such a provision a shareholder is entitled to the payment of dividend in cash. *Table A* provides for the capitalisation of profits by an ordinary resolution of the members in general meeting (or a written resolution) upon the recommendation of the directors.

Where there is an allotment of bonus shares, the company must make a return of the allotment and since the shares are allotted for a consideration other than cash, the contract constituting the title of the allottees must be registered. *Table A* allows the directors to authorise any person to enter into an agreement on behalf of the members who are to be allotted bonus shares, and this would obviate the need to make a contract with them all.

The actual distribution of the bonus shares among the various classes of shareholders will be based on their right to receive dividend unless the articles or terms of issue otherwise provide.

Reserves

A company is not in general bound to allocate certain of its profits to reserves, although it must *on a redemption or purchase of shares* out of profits set up a *capital redemption reserve*, and it may be that the company is bound under a contract with its debenture holders to set aside a certain sum by way of a reserve to redeem the debentures.



Nevertheless, the articles may provide for the directors to set up *reserve funds for dividend equalisation* or *to meet future liabilities*. *Table A* does not give such a power, it being implied that provided the reserves are distributable the shareholders are entitled to them. However, where such a power exists, the directors may decide to set aside all the profits, even if this means that no dividend is paid on the preference or ordinary shares, though in such circumstances there may be a petition under s 994 by a member or members on the grounds of 'unfair prejudice' (see Chapter 14).

See p. 276

Essay questions

1 Explain the rules of company law which regulate the making of distributions by public companies, private companies and investment companies. Indicate also the consequences which can follow the making of an unlawful distribution.

(*The Association of Chartered Certified Accountants*)

2 The summarised draft balance sheet of a company as on 31 March 200X was as follows:

	£000
Fixed assets at cost less depreciation	
Land and buildings	1,500
Machinery	60
Fixtures	15
	1,575
Net current assets	925
	2,500
Ordinary share capital	1,600
Profit and loss account	900
	2,500

An independent professional valuation undertaken on 31 March 200X showed valuations of £1,400,000 and £50,000 for the land and buildings and machinery respectively which the directors decided to incorporate into the company's accounting records. They considered that the value of the fixtures was not less than £15,000.

Advise the directors of the maximum amount of profit *legally* available for distribution explaining fully the relevant statutory requirements.

(*The Institute of Chartered Accountants in England and Wales*)

3 Fred, George and Harry, who run a business buying and selling antiques, have been advised to form a private company to run the business. They seek your advice on the major differences

between their present general partnership and the proposed company, and in particular as to the rules relating to company names, contracts entered into prior to the formation of the company and the concept of maintenance of share capital.

(*The Institute of Chartered Secretaries and Administrators*)

4 Explain the rules applicable to the determination and payment of dividends.

(*The Institute of Company Accountants*)

5 Give the facts in ***Macaura* v *Northern Assurance Co Ltd*** [1925] AC 619 and explain the importance of its *ratio decidendi.* (*University of Paisley*)

6 H plc wishes to change its articles of association to add a clause which states 'any director of the company may be removed from office if all other directors give notice in writing of their desire that the named director be so removed'. You are required to explain the procedure for alteration and discuss the difficulties the company might encounter in adding this new clause.

(*The Chartered Institute of Management Accountants*)

7 (a) Why must every company have a registered office? What information about the registered office must be published? To what extent can the registered office of the company be changed and what procedures must be observed when it is so changed?

(b) In the absence of a company taking advantage of alternative provisions under the Companies Act 2006, what statutory records must be kept at a company's registered office?

(*The Association of Chartered Certified Accountants*)

Aid to learning on distributions

These objective testing questions are taken from pilot papers on objective testing published by the Institute of Chartered Accountants in England and Wales and are retained because of their high quality. They take the place in this chapter of the test your knowledge questions devised by the author.

Question A

A dividend may not be paid by reference to a set of financial statements which carry a qualified audit report unless the auditor states in writing that the matter is not material in determining whether the proposed dividend is illegal under the Companies Act. Which of the following might be considered material?

A A qualification disagreeing with certain reorganisation costs being classified as extraordinary.
B A qualification disagreeing with the carrying forward of goodwill arising on consolidation in the consolidated balance sheet.
C A qualification for the non-disclosure of loans to directors.
D A qualification arising from a disagreement as to the book value of stocks.

Answer to question A

The answer is **D** since disagreement as to the book value of stocks will affect the amount of realised profits in the profit and loss account.

A is a matter of classification, but the requirement for profits available for dividend is whether or not they have been realised.

B is a qualification affecting the consolidated accounts, but the write-off of goodwill on consolidation will not affect the distributable profits of the holding company.

C The auditors are required to disclose loans to directors if not included in the accounts or notes, but this will not affect the distributable profits.

Question B

With reference to the following information, answer questions 1 to 6.

The table below shows the financial status of two companies, Alpha and Beta, at the year ending 31 March 20XX.

	Alpha	*Beta*
	£m	£m
Unrealised revaluation surplus/(deficit)	350	(300)
Realised capital profits	250	150
Realised revenue profits brought forward	150	150
Realised revenue profits/(loss) for the year	50	(50)

At all times the net assets of the companies after distribution will exceed the statutory minimum.

1 If Alpha is a limited but not a public limited company, what are the profits available for distribution as dividend of Alpha Ltd?

A £50 m **B** £200 m **C** £450 m **D** £800 m

2 If Alpha is a public limited company, what are the profits available for distribution as dividend of Alpha plc?

A £50 m **B** £200 m **C** £450 m **D** £800 m

3 If Alpha is a public limited company treated as an investment company, what are the profits available for distribution as dividend of Alpha plc?

A £50 m **B** £200 m **C** £450 m **D** £800 m

4 If Beta is a limited but not a public limited company, what are the profits available for distribution as dividend of Beta Ltd if the revaluation deficit arises on a revaluation of all the fixed assets?

A Nil **B** £50 m **C** £100 m **D** £250 m

5 If Beta is a public limited company, what are the profits available for distribution as dividend of Beta plc?

A Nil **B** £50 m **C** £100 m **D** £250 m

6 If Beta is a public limited company treated as an investment company, what are the profits available for distribution as dividend of Beta plc?

A Nil **B** £50 m **C** £100 m **D** £250 m

Answers to question B

Q.1 *The answer* is **C**, £450 m.

A only takes account of the current year's realised profits but it is accumulated realised profits that are taken into account.

B excludes capital profits which are available if realised.

D includes revaluation surplus which is not available.

Q.2 *The answer is C*. There is no difference between a public and private company in such a case.

Q.3 *The answer is B*, i.e. realised *revenue* profits.

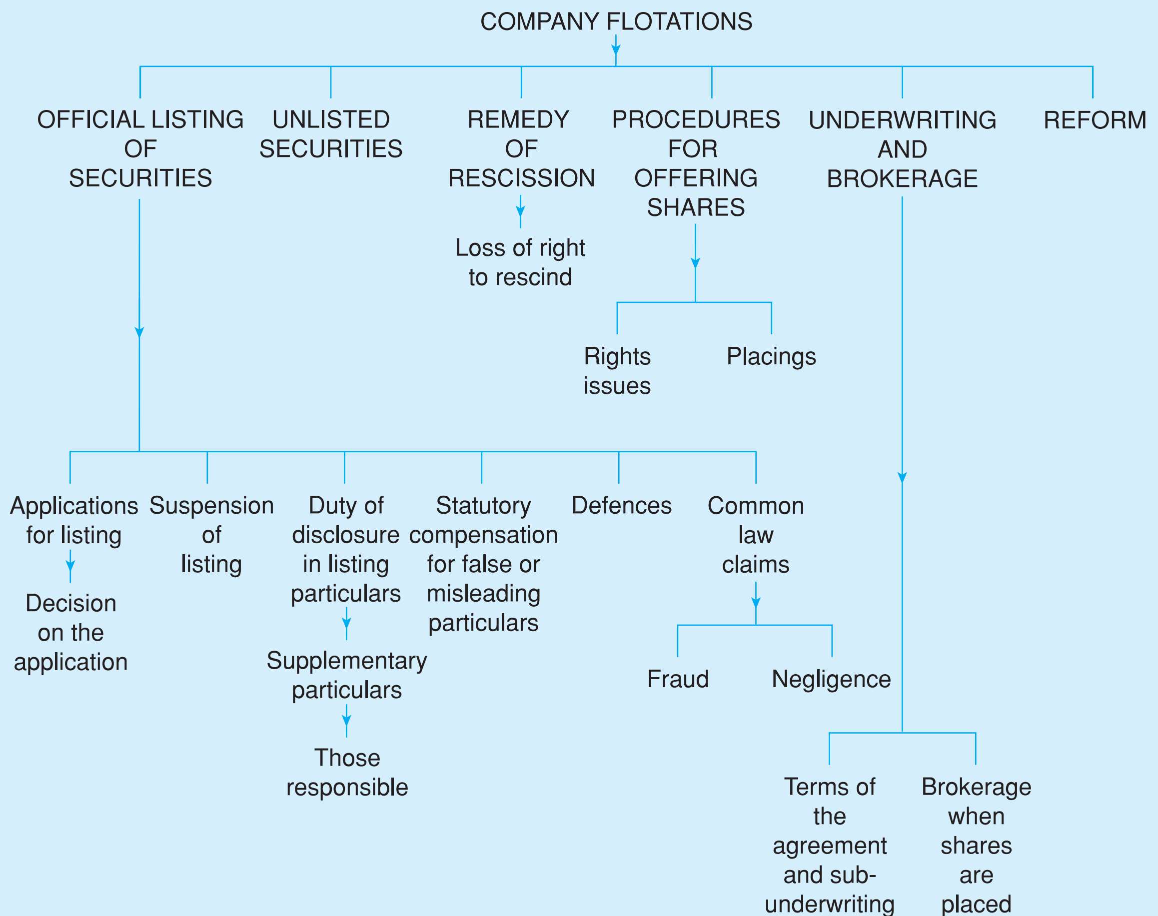
Q.4 *The answer is D*, £250 m. Realised losses must be taken into account but revaluation deficit need not be so long as it relates to all the fixed assets (excluding goodwill).

Q.5 *The answer is A*. In a public company a further limitation is that the net assets must not be reduced below the capital and non-distributable reserves.

Q.6 *The answer is C*, £100 m, since capital profits and losses need not be taken into account provided the company qualifies as an investment company.

Visit **www.mylawchamber.co.uk/keenancompany** to access study support resources including practice exam questions with guidance, weblinks, legal newsfeed, answers to questions in this chapter, legal updates and further reading.

10 Company flotations



The Financial Services and Markets Act 2000 made major and important changes in the regulation of listing particulars and prospectuses as part of the new regime of investor protection. Section and other references are to the Act of 2000 (FSMA) unless otherwise indicated.

The official system for listing securities on an investment exchange

Under s 72 the UK Listing Authority (UKLA) is part of the Markets and Exchanges division of the Financial Services Authority (FSA) under the Director of Markets and Exchanges. This merger took effect in November 2003. Its main task is to determine whether securities meet the requirements to be admitted to and retained on the Official List of the relevant investment exchange, the London Stock Exchange. Permission to actually trade the securities when they have been admitted to the List is a matter for the London Stock Exchange.

The EC Transparency Directive (Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004) went into effect in the UK on 20 January 2007. The EC Transparency Directive is wide-ranging dealing with areas such as notification of major shareholdings, dissemination of information, new requirements on the content and timing of financial information such as annual reports and half-yearly reports. Under the Companies Act 2006, the FSA has been given the power to make rules for the purposes of implemented the EC Transparency Directive. As part of this, the FSA has amended the Listing Rules and updated the Disclosure Rules Sourcebook which is now known as the Disclosure and Transparency Rules.

The new Listing Rules, Prospectus Rules and Disclosure and Transparency now make up the Part VI Rules of the FSA's *Handbook of Rules* replacing the former *UKLA Listing Rules* (the 'Purple Book') which were substantially the same as the former *London Stock Exchange Listing Rules* (the 'Yellow Book'). These were adopted when the FSA took over the function of competent authority for listing from the London Stock Exchange in 2000. When the FSA performs functions as the competent authority under Part VI of FSM, in that context the name UKLA is used.

Applications for listing

The Listing Rules (LR) apply to issuers listed, or applying for listing, on the FSA's Official List and to their sponsors. There is a two-tier listing regime: premium listings for equity shares with super-equivalent standards; and standard listings for all other securities listed on an EU directive minimum basis (LR 5). An issuer with a standard listing has fewer obligations under the LR than an issuer with a premium listing. Issuers must comply with the rules that are applicable to every security in the category of listing which applies to each security the issuer has listed.

The application by a company must comply with the LR. However, an application may be refused if granting it would be detrimental to the interests of investors (s 75). Of particular importance is that, in the case of both premium and standard listing, 25 per cent of the company's shares must be in public hands and not, for example, in those of the directors

(LR 6.1.19R and LR 14.2.2R, respectively). In addition the expected market value of the securities to be listed must be at least £700,000 in the case of shares and £200,000 in the case of debt securities (LR 2.2.7R (1)). Securities of a lower value can be admitted to listing if the relevant authority is satisfied that adequate marketability can be expected (LR 2.2.8G). The Treasury, which has regulatory powers in the field of financial services, has, for example, designated private companies as being unlistable.

Decision on the application

The FSA has six months to consider an application. Where listing is granted, the applicant must be given written notice. If the FSA refuses the application, there are rejection procedures that the FSA must follow, including the right of the applicant to appeal to the Financial Services and Markets Tribunal set up under Part IX of the FSMA (ss 75 and 76).

Discontinuance and suspension of listing

The FSA has discretion to suspend a listing for a while or discontinue it altogether where it is satisfied that there are special circumstances that preclude normal dealing in the shares, as where there appears to be insider dealing in them on the basis of inside information, e.g. a bid for the company not known to the public. The FSA will often need to act quickly and so need not use its rejection procedures, but if it refuses to cancel its decision to suspend a listing, it will have to follow rejection procedures. In any case, the holders of the securities cannot challenge the decisions of the FSA by judicial review through the courts (see ss 77 and 78 and ***R*** v ***International Stock Exchange of the United Kingdom and the Republic of Ireland, ex parte Else (1982) Ltd*** [1993] BCC 11).

Listing particulars and other documents

Prospectuses and listing particulars must be approved by the FSA. Publication and advertising before the shares can actually be listed is covered in the Prospectus Rules. The requirements for publication of a prospectus are set out in the Prospectus Rules. The requirement to file a copy of a prospectus or listing particulars with the Registrar of Companies however is no longer applicable (s 83 repealed by Prospectus Regulations 2005/1433, Sch 1, para 4).

General duty of disclosure in listing particulars

In addition to detailed information required by the Listing Rules and any special conditions imposed by the FSA that are beyond the scope of this text, listing particulars must contain all such information as investors and their professional advisers would reasonably require and reasonably expect to find there for the purpose of making an informed assessment of:

- the assets and liabilities, financial position, profits and losses and prospects of the issuer of the securities; and
- the rights attaching to the securities (s 80(1) and (2)).

Once a class of securities has been issued, further issues still require new listing particulars unless it is, for example, a bonus issue.

Supplementary listing particulars

Those responsible for the original particulars are under a duty to notify any change or new matter of which they become aware (s 81). Supplementary particulars must be submitted by the issuer for approval and then filed with the Registrar of Companies and published.

Those responsible are defined by the Treasury in statutory instruments (s 79(3)). They include the issuer or sponsor, such as a merchant (or investment) bank and, of course, the directors of the issuing company.

Default sanctions

The FSA can publicly censure (name and shame) or fine anyone who was a director at the time and was knowingly concerned in the contravention of the Listing Rules. Sponsors such as investment banks may be censured but not fined (ss 89 and 91). In imposing a public reprimand or fine, the FSA must follow its disciplinary procedures (ss 89 and 92–94). Offering securities to the public before a prospectus is issued is an offence punishable by up to two years' imprisonment as well as a fine (s 85(1)–(3)).

The FSA can launch an *investigation* into suspected contravention of the rules (s 97) and institute legal proceedings on behalf of investors for compensation and/or disgorgement of profits for breach of any obligation under the FSMA 2000 and can order an authorised firm to make payment without taking court action (ss 382 and 383).

So far as *investors* are concerned, there is a *separate civil action* for them against anyone responsible for misleading listing particulars and prospectuses (see below).

Prospectuses

When will a prospectus, as distinct from listing particulars, be used to make an issue of shares? Generally, a prospectus must be produced when securities are being issued to the public while the company is still seeking a listing, provided the shares are being offered for the first time. More specifically in order to evaluate the need for a prospectus in conjunction with any issue or offering of shares, one must consider:

1 whether the securities are of a kind to which the Prospectus Rules apply (Sch 11A); or
2 whether the securities are of a kind being offered in circumstances falling within the s 86(1) private placement exemption for which Prospectus Rules 1.2.2 R offers exemption; or
3 whether the Prospectus Rules 1.2.3 R exemption in relation to admissions to trading apply; or
4 whether an application for admission to trading is being made.

If so, a prospectus will be required unless one of the exemptions described above applies (ss 85 and 86).

Sponsors

The FSA requires all applicants for listing to use the services of a sponsor, e.g. an FSA-authorised investment bank, to ensure that the applicant company complies with all its obligations. The FSA may refuse an application to be an approved sponsor (s 88). Sponsors

may be censured by the FSA but not fined for breaching any rules on listing imposed on them (s 89).

Compensation for false or misleading statements

Errors in listing particulars and prospectuses make any person responsible for the relevant document liable for any loss caused thereby to anyone acquiring the securities that the document covers (s 90).

Errors include:

- untrue or misleading statements in the document;
- the omission of any matter requiring inclusion by the Listing Rules, except:
  (a) a case where there is no such matter; or
  (b) an omission that has been authorised by the FSA.

The fact that matter required by the Listing Rules is omitted is to be taken as a statement that there is no such matter (ss 82 and 90(3)).

Statutory defences

A person responsible (see below) can avoid liability where he made such enquiries as were reasonable and reasonably believed that the statement was true and not misleading (or properly omitted) when the document was submitted for approval by the FSA, provided that when the securities were later acquired:

- he continued in that belief;
- it was not reasonably practicable to bring the correction to the attention of those likely to acquire the securities;
- he had taken all reasonable steps to bring a correction to their attention; or
- he ought reasonably to be excused because he believed it when the dealings began and now too much time has elapsed (Sch 10, para 1).

There is also a defence where, although no correction was made, the person responsible did not reasonably believe the matter was material and where he reasonably believed a correction had been published. Furthermore, no one is liable to a person who acquired the securities knowing of the error (Sch 10, paras 3, 6 and 7).

Statements by experts

If the statement is made by or on the authority of an expert, such as an accountant, valuer or engineer, and is included with his consent, other persons responsible for the document have only to prove that they reasonably believed that the expert was competent and had consented. There is no need to show that there was reasonable belief in their truth. A correction need only be to the effect that the expert was not competent or had not consented. There is no liability for statements by public officials or in official documents, provided that they have been fairly and accurately reproduced (Sch 10, paras 2, 4, 5 and 8).

The duty to report significant changes continues until dealings begin and after that there is a duty to make reasonable endeavours to issue a correction notice unless, given lapse of time, the document is no longer relevant (ss 80, 81, 90 and Sch 10).

Dealings in the after-market

Acquiring securities includes contracting to acquire them or any interest in them not merely at the time of listing but seemingly also in secondary dealings after issue called the after-market (s 90(7)).

Persons responsible

Under s 79(3) the Treasury defines by statutory instrument those responsible for listing particulars and prospectuses. Currently it is the following:

- the issuer of the securities, e.g. the sponsoring investment bank;
- the directors and proposed directors of the issuing company;
- consenting experts for their own part of the particulars or prospectus.

Common law claims

These are expressly preserved by s 90(6). The position is as follows:

- The normal contractual remedies for breach of contract or misrepresentation apply, including rescission of the contract (but see below). These remedies are against the company.
- Actions against directors, auditors or sponsors will have to be based on the tort of deceit or the tort of negligence since there is no contractual nexus with these persons.

It is not easy to prove deceit since some form of dishonesty must be shown. The burden of proof in negligence is on the claimant but is not so difficult to prove. However, the defendant will only be liable if a duty of care exists and is broken and the loss was within the contemplation of the defendant. The general rule of foreseeable loss is probably too wide for this type of case. The relevant case law appears below.

(a) Fraud claims

Derry* v *Peek (1889) 14 App Cas 337

The Plymouth, Devonport and District Tramways Co had power under a special Act of Parliament to run trams by animal power and, with the consent of the Board of Trade, by mechanical and steam power. Derry and the other directors of the company issued a prospectus inviting the public to apply for shares in the company and stating that the company had power to run trams by steam power and claiming that considerable economies would result. The directors assumed that the Board of Trade would grant its consent as a matter of course, but in the event the Board refused permission for certain parts of the tramway, and the company went into liquidation. Peek, who had subscribed for shares under the prospectus, brought this action against the directors for fraud.

Held – by the House of Lords – that before a statement can be regarded as fraudulent at common law, it must be shown that it was made knowing it to be untrue, or not believing it to be true, or recklessly, not caring whether it be true or false. On the facts of the case, it appeared that the directors honestly believed that permission to run the trams by steam power would be granted as a matter of course by the Board of Trade, and thus they were not liable for fraud.

Comment

Fraud must be proved to the criminal standard, i.e. beyond a reasonable doubt; not to the civil standard, i.e. on a balance of probabilities. It is thus not easy to sustain an action based on fraud. Furthermore, it will be noticed from this case that the mere fact that no grounds exist for believing a false statement does not of itself constitute fraud. Dishonesty is required.

(b) Negligence claims

See p. 504

As regards *claims in negligence* by those who have purchased in the market, it appears that there is no duty of care on the part of the makers of false statements in listing particulars to those who make market purchases, though there is a duty to subscribers direct from the company. This follows from the restrictive approach to liability in negligence by the House of Lords in ***Caparo Industries*** v ***Dickman***, 1990 (see Chapter 23). This restrictive approach was applied by Mervyn Davies J in the High Court in ***Al-Nakib Investments (Jersey) Ltd*** v ***Longcroft*** [1990] 3 All ER 321. The claimant company sued the directors of a company, claiming that it had bought shares in the company under an allegedly false prospectus. This it was said had induced the purchase of 400,000 shares in the newly floated company under the prospectus and directly from the company and had also induced the purchase of other shares in the company on the stock market. The judge held that since the purpose of the prospectus was to invite subscriptions direct to the company and not purchases through the stock market there was no duty of care in negligence in regard to the market purchases, though there was a duty in regard to the shares purchased directly from the company.

There has been some movement in the position at common law since ***Possfund Custodian Trustee Ltd*** v ***Victor Derek Diamond*** [1996] 1 WLR 1351. Mr Justice Lightman in the High Court stated that nowadays it is at least arguable that those who are responsible for issuing listing particulars and prospectuses owe a duty of care to subscribers and those who purchase in what may be described as the after-market in reliance on the prospectus. This could place liability on the company's directors and its advisers if they are negligent.

Purchasers in the after-market following an issue with a listing are protected by s 90(7) in terms of statutory remedies. The only advantage of claiming at common law under ***Possfund*** is that not all of the FSMA 2000 statutory defences are available to the defendant (see above). The only defence at common law is a reasonable belief in the truth of the statement.

Offers of unlisted securities

In previous editions we have discussed offers on the Unlisted Securities Market, which has been replaced by the Alternative Investment Market (AIM). These securities are not part of the FSMA 2000. The Prospectus Regulations 2005/1433 repeal the Public Offers of Securities Regulations 1995 which have governed public offers of unlisted securities in both unquoted and AIM companies for some 10 years. The contents of prospectuses issued by any companies in the UK (whether they be listed, AIM, Ofex or unquoted companies) are now governed by the Prospectus Regulations.

The remedy of rescission

The main remedy for loss resulting from a misstatement in listing particulars is, as we have seen, damages based either on breach of a statutory duty under the FSMA and the Misrepresentation Act 1967, or at common law under the principles of liability for negligent misstatements.

The remedy of rescission involves taking the name of the shareholder off the register of members and returning money paid to the company by him. This is against the modern trend because it goes contrary to the principle of protection of the creditors' buffer which is the major purpose of the many statutory rules relating to capital maintenance.

The modern trend is to leave the shareholder's capital in the company but allow him a remedy for money compensation if the shares are less valuable because of the misstatement and against those who were responsible for the misstatement, such as directors or experts.

The cases which are illustrative of the remedy of rescission are rather old and are not referred to here. Suffice it to say that in order to obtain rescission, the shareholder must prove a material misstatement of fact not opinion (the principles in negligence cover actions for damages for opinions), and that the misstatement induced the subscription for the shares. The action can only be brought by the subscriber for the shares under the prospectus.

The right to rescind is a fragile one, being lost unless the action is brought quickly; or if the contract is affirmed, as where the shareholder has attended a meeting and voted the shares; or where the company is in liquidation or liquidation is imminent.

Procedures for issuing shares

As we shall see in Chapter 11, shareholders in companies today have pre-emption rights, i.e. a right to have new issues offered to them first (s 561, CA 2006). A company that is proposing to allot equity securities (defined in s 560, CA 2006) must offer them to existing shareholders first (that is, on a pre-emptive basis). In essence, a shareholder should be able to protect his proportion of the total equity of a company by having the opportunity to subscribe for any issue of equity securities. This is subject to various exceptions categorised in s 561(a)(5), CA 2006. The company can disapply this right by special resolution (or in the case of private companies by the articles). Listed companies usually propose resolutions to disapply statutory pre-emption rights at each annual general meeting under CA 2006 ss 570 and 571. Listed companies must also comply with pre-emption rules contained in LR 9.3.11R and LR 9.3.12R.

However, in the case of listed companies, since the major shareholders of listed companies are institutions, such as insurance companies, which like to receive offers of new shares, listed companies are in general restricted to a disapplication of only up to 5 per cent of the existing shares. Therefore, *rights issues to existing shareholders* are the major way of financing listed companies in capital terms and not offers directly to the public. The circular that accompanies the rights issue to shareholders is a prospectus and must be approved by the FSA. The circular must contain the detailed requirements set out in the Listing Rules (LR 13.8.2R). The shares are allotted to the shareholders under provisional allotment letters and these can be traded in the market nil paid while the rights offer is open for acceptance. Thus the shareholder can sell his rights without paying the company for them. The purchaser from the

shareholder will pay the market price to the shareholder and since rights issues are at a discount to the market value, but not, of course, less than par value, the shareholder will make a profit and will be left with money when he has later paid the company the discounted price. Any shares remaining, as where a shareholder does nothing, will be *placed* by the company's brokers with their clients and any not so taken up will be left with the merchant or investment bank that has underwritten the issue or any sub-underwriters. These are then the two main methods these days of raising equity finance by listed companies. A placing will be on the terms of the rights issue particulars but will not even require those, in full form at least, if the offer is to no more than 50 persons or to professional investors.

Underwriting

Before a company's shares or debentures are issued, agreement is reached with an investment bank that is prepared for a commission to take up (or underwrite) the whole or a part of the shares being offered if not all of the shares are taken up. Under the LR, the underwriting agreement is a material contract. Moreover, where the circular is a prospectus the underwriting agreement must be included into the circular through a summary of its material sections.

It is usual to underwrite even when a company is sound and the shares are popular, since changes, for example in the international situation or the financial state of the country, can affect an issue adversely.

Due to the fact that the payment of underwriting commission could be used as a device to issue shares at a discount, the payment of underwriting commission is controlled by s 553(2) of the CA 2006. Section 553 of the CA 2006 provides that a company may pay a commission to a person in consideration of his subscribing or agreeing to subscribe (whether absolutely or conditionally) for shares in the company, or procuring or agreeing to procure subscriptions (whether absolute or conditional) for shares in the company if: (a) the payment of the commission is authorised by the company's articles; and (b) the commission paid or agreed to be paid does not exceed (i) 10 per cent of the price at which the shares are issued; or (ii) the amount or rate authorised by the articles, whichever is the less.

If there is in existence a *share premium account*, this may be applied to pay the commission on an issue of shares or debentures (s 610, CA 2006).

Terms of the agreement

The underwriter agrees to underwrite a stated number of shares on the terms of a specified prospectus or particulars so that an alteration in these documents before issue may render the underwriting agreement void if it materially increases the risk taken by the underwriters. Thus, in ***Warner International & Overseas Engineering Co Ltd*** v ***Kilburn, Brown & Co*** (1914) 84 LJ KB 365 a company altered the draft prospectus on which an underwriting agreement was based by reducing the minimum subscription to be received before allotment from £15,000 to £100 and by stating also that, instead of buying a business it was to acquire by one payment from the proceeds of the issue, it would buy the business by instalments out of future issues. It was held by the Court of Appeal that the underwriters were released from their contract.

The underwriter agrees to take up the balance of shares (if any) not taken up in the issue, and authorises a director or other agent of the company to apply for the shares on the underwriter's behalf. This means that the company can ensure the allotment of the shares to the underwriter, and thus have an action for the full price, and not merely an action for damages if the underwriter merely refuses to apply for them. The authority to apply is expressed to be irrevocable.

Finally, the company agrees to pay a certain percentage of the nominal value of the underwritten shares as commission. The amount of the commission is a matter between the parties and the UKLA, but it must be in line with the risk and not excessive in terms of it if listing is to be obtained.

The liability of the underwriter ends when persons subscribe for the shares, and he cannot be called on to pay if allottees do not meet their liabilities.

Sub-underwriting

Underwriters may enter into sub-underwriting contracts to relieve themselves of the whole or part of their liability. The underwriter pays a commission to the sub-underwriters.

Brokerage

This is a commission paid over to a bank, stockbroker, or issuing house for placing shares. The difference between brokerage and underwriting is that the broker does not agree to take the shares himself, but merely agrees to try to find purchasers. The payment of brokerage could also lead to an issue of shares at a discount and yet it is not controlled by the CA 2006, s 552(3), providing that s 553 shall not affect the power of any company to pay brokerage. However, it can only be paid to a bank, market maker, or issuing house and the rate must be reasonable, though the precise rate is a matter for negotiation according to the degree of risk (***Metropolitan Coal Consumers' Association*** v ***Scrimgeour*** [1895] 2 QB 604).

Reform

The Prospectus Directive: EU developments

This background note is included mainly because of the effect that the EU Prospectus Directive has had on the position of the AIM. As already noted this is a market that has proven quite attractive to the smaller plc wishing to trade its shares on a public market perhaps on conversion from a private company.

The Prospectus Directive came into force on 31 December 2003. Member states were required to implement the new regime by 1 July 2005. On 1 July 2005, the Prospectus Directive was implemented in the UK. In addition to changes to the FSMA and to the Listing Rules of the FSA necessitated by these directives, the FSA introduced further changes to the listing regime.

The main principle

This is that if an issuer is making an offer of securities to the public or its securities are being admitted to trading on a regulated market in the EU it must publish a prospectus and get it approved by the competent authority in what is called its 'home member state'. When the prospectus has been approved in that state it may then be used to offer shares or gain admission to regulated markets in all EU member states without the issuer having to publish any further information or having to get further approval for the document in those member states. The Directive sets out the procedure for identifying an issuer's home member state and states when a prospectus is required and what it should contain. The Directive relates only to the prospectus and does not govern admission criteria and continuing obligations. The UK and other member states will be able to impose additional obligations in those areas but cannot impose any additional disclosure requirements so far as the prospectus is concerned.

Home member state for EU issuers

The home member state for an EU issuer will be the member state in which it has its registered office.

Example

A German company decides to list its shares on the London Stock Exchange. It is not offering shares in Germany or seeking admission of the shares to a regulated market in Germany. Its home member state will be Germany and so the German competent authority will approve the prospectus. The competent authority in England will then have to accept that prospectus as approved and will not be able to require the issuer to publish any additional information. It will have discretion to assess whether the issuer satisfies any eligibility criteria for admission to listing or trading set by it.

The effect on the AIM

The Directive covers secondary markets such as the AIM and in fact one of the European Commission's objects is to catch start-up and high-tech companies and apply more onerous requirements to them. This could have affected the AIM, however, the London Stock Exchange made the AIM an unregulated market from 12 October 2004 in order to avoid the application of the Directive.

Non-EU issuers

These issuers have also been affected by the Prospectus Directive. In regard to non-EU issuers whose securities are already admitted to trading on an EU regulated market the issuer has to choose as its home member state the member state where its securities are first offered to the public or where its securities are first admitted to trading in the EU after the Directive comes into force, i.e. after 31 December 2003. The issuer had to notify its decision to the competent authority of its chosen member state by 31 December 2005.

For non-EU issuers whose securities are not already admitted to a regulated market in the EU the home member state will be the member state where the securities are offered to the public or admitted to trading in the EU for the first time (this is at the choice of the issuer whether or not the issuer has to publish a prospectus) after the date of entry into force of the Directive, i.e. 31 December 2003.