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.

FSA Listing Rules review

The FSA has reviewed the UK Listing Rules resulting in an overhaul of the listing regime on the London Stock Exchange. This review was to some extent driven by the Prospectus Directive and the result has been the issuance of the FSA Handbook containing the Disclosure Rules, Listing Rules and the Prospectus Rules. As a result of that review, the FSA has made a number of changes to the listing regime that have come into effect.

The two-tier listing regime still stays; however, the two branches are now called 'premium' and 'standard'. Premium listing issuers must meet 'super-equivalent' standards (which also existed previously). These are standards imposed by the FSA that go beyond relevant EU directive standards. Those issuers who have securities that do not meet premium listing standards will have to undertake standard listing. A standard listing involves the EU directive minimum standards (just as it did before). One of the major reform goals which the new requirements attempt to promote is increased harmonisation of obligations within a listing segment regardless of whether the issuer is incorporated in the UK or overseas.

Essay questions

1 'The Financial Services and Markets Act 2000 has provided a more rational and fair procedure to compensate investors who are misled by a misrepresentation in a prospectus (or listing particulars) on an issue of shares by a company. Nevertheless, the common law remedies remain of importance.'

Discuss. (*The Institute of Chartered Secretaries and Administrators*)

2 Explain 'rescission' and the loss of the right to rescind in respect of prospectuses.

(*The Institute of Company Accountants*)

3 Harriet subscribed for shares in Overseas plc on the basis of the prospectus which showed that for the previous five years the company had earned substantial and increasing profits. Shortly after allotment she sold half her shares to Georgina at a large profit. The information in the prospectus was correct but it omitted to mention that much of the business was in the Middle East and, because of various wars, the profits had been materially reduced. The shares are now worth only half the price paid by Harriet. Compare and contrast the remedies available to Harriet and Georgina. (*The Institute of Company Accountants*)

4 (a) 'The law treats a registered company as a separate legal person from its members. To this general rule there are several exceptions.'

Examine the statement, giving two examples of circumstances in which the court will look at the reality behind the legal facade.

(b) Dairy Products Limited employed Roundsman to distribute their products in and around Saltash. A clause in the contract of employment provided that in the event of his leaving the employment he would not solicit the company's customers for a period of three years. Roundsman assiduously collected the names and made a list of all their customers, left his employment after three months and formed a company, Farm Produce Limited, which competed with Dairy Products. All the shares in Farm Produce were allotted to Mrs Roundsman and her father, both of whom began soliciting the customers of Dairy Products with the help of the list produced by Roundsman.

Advise Dairy Products Ltd. (*University of Plymouth*)

5 J is the managing director of Z plc, a listed company. She has recently seen the end of year accounts for Z plc which are to be published in three weeks' time. These accounts show the company to have substantial liquid assets and J believes that Z plc is likely to attract takeover bidders when the accounts are published. J has decided that she should build up her own personal shareholding in Z plc and has asked you, the company's finance director, whether she can borrow £30,000 from the company and use it to purchase more equity shares in the company.

You are required to advise J. (*The Chartered Institute of Management 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 A public company wishes to have its shares listed on the London Stock Exchange. What percentage of its shares must be in the ownership of the public?

A 10 per cent B 20 per cent C 25 per cent D 30 per cent

2 Fylde plc has issued listing particulars containing a material misrepresentation in a report by an accountant who did not consent to the inclusion of the report in the form in which it was included. Fred purchased shares on the stock market from Joe who was an original subscriber under the listing particulars. Fred is now suing the directors of Fylde plc for monetary compensation.

A Fred's action against the directors will succeed because the directors are liable for all statements in listing particulars without any defence.
B Fred's action against the directors will fail because the directors have a defence under the Financial Services and Markets Act 2000.
C Fred's action against the directors will succeed because the accountant did not consent to the inclusion of his report.
D Fred's action will fail because he was not an original subscriber.

3 Tay plc has issued listing particulars containing a material misrepresentation. Relying on the particulars, Alf, Bert and Clare subscribed for shares. Alf sold half of his shares immediately. Bert went to an extraordinary general meeting of Tay and voted on a number of matters. Who can rescind the contract to take the shares?

A Clare B Clare and Bert C Bert D Alf and Bert

4 Which of the following expressions best describes the relationship of company promoter to the company?

A Fiduciary B Equitable C Agent to a principal D Commercial

5 Prior to the incorporation of Ouse Ltd, Mark, its promoter, made a contract on behalf of the company. Who will be liable if the contract is breached?

A Mark.
B Ouse Ltd.
C The shareholders of Ouse Ltd.
D The directors of Ouse Ltd.

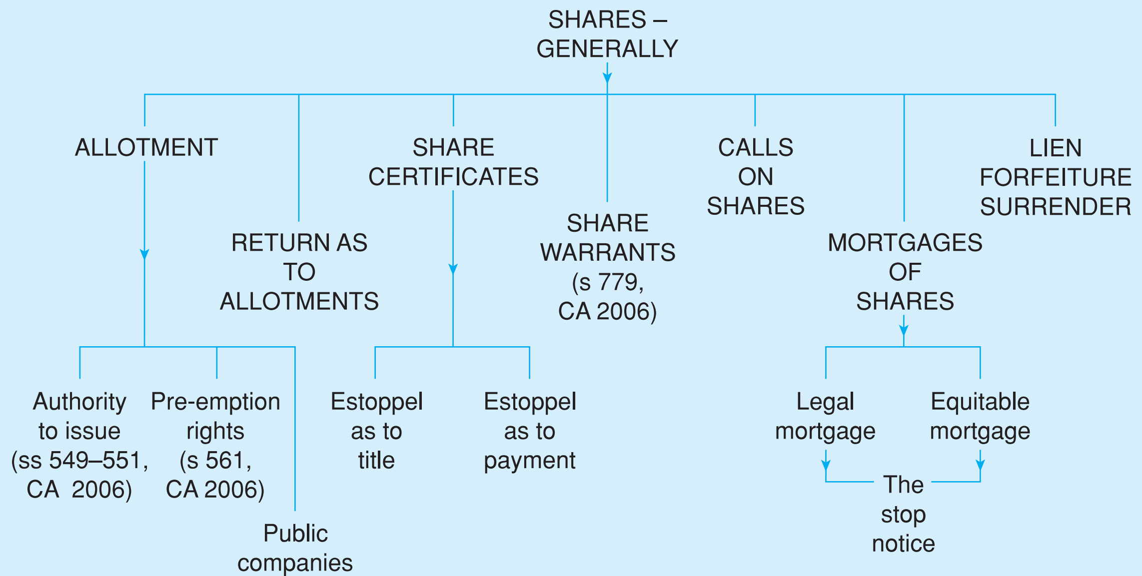
6 Alf and Bert formed a company called Tyne Ltd. They became the sole directors and took up 50 per cent of the shares, the other shares being allotted to 15 other people. Alf and Bert sold their business to Tyne Ltd for £130,000, although it was valued at £120,000. How should the profit be dealt with?

- **A** Alf and Bert may keep it.
- **B** Alf and Bert may keep it if they disclose it to the board of directors and obtain the consent of the board.
- **C** Alf and Bert may keep it if they disclose it to all the other shareholders and obtain their consent.
- **D** Alf and Bert cannot keep it in any circumstances.

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

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.

11 Shares – generally



Section 540 of the CA 2006 defines the term 'shares'. Section 540(1) of the CA 2006 identifies that the term 'share', in relation to a company, means share in the company's share capital. A company's shares may no longer be converted into stock (CA 2006, s 540(2)). Section 540(3) of the CA 2006 provides that stock created before the commencement of Part 17 of the CA 2006 may be reconverted into shares. The procedure for this is set forth in s 620, CA 2006. CA 2006, s 540(4)(a) provides that in the Companies Acts references to shares include stock, except where a distinction between share and stock is express or implied. CA 2006, s 540(4)(b), provides that where references to a number of shares include an amount of stock where the context admits the reference to shares shall be read as including stock. References to 'shares' in the Companies Act 1985 and 2006 includes stock. However, now under s 540(2) of the CA 2006 it is no longer possible for a company that has stock at the date this provision came into force (1 October 2009) to reconvert its stock back into shares (s 620, CA 2006).

Prior to passage of the Companies Act 2006, CA 1985, s 14 provided that the memorandum and articles when registered bind the company and its members to the same extent as if they respectively were signed and sealed by each member and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles. Under the CA 2006, s 33, the provisions of a company are still a unique kind of contract that binds the company and its members. CA 2006, s 33 remains exempt from the Contracts (Rights of Thirds Parties) Act 1999 just as CA 1985, s 14 did. This is so that provisions of a company's constitution will not give rights to persons other than the company and its members.

Under CA 2006, s 303, members may require directors to call general meetings and move resolutions (CA 2006, s 303(5)(a)). They also have the right to inspect certain records and documents which a company is obliged to keep (CA 2006, s 358) and the right to appoint a proxy to represent them at meetings of the company (CA 2006, s 324). Financially, it represents what a member must pay or has paid for the share, and it provides a basis for the calculation of distributions of profits by means of dividends. The assets of the company are owned *by the company*. The members do not have a legal or equitable interest in them (***Macaura* v *Northern Assurance***, 1925 (see Chapter 1), and although share capital is in a sense a liability, it is not in the nature of a debt owed by the company, and on a winding-up the shareholders will receive what is left, if anything, after payment of the company's debts and liabilities. Shares are personal estate and not real estate. They are, therefore, in the same category as money or goods. The section removes doubts raised by early cases as to whether shares in companies formed mainly to hold and manage land were not themselves of the legal nature of realty.

See p. 5

Subscribers' contract

Where shares or debentures are offered to existing members, which is obligatory unless waived by special resolution of the members in plcs, the letter of rights or *provisional letter of allotment* is an offer, and no notification of acceptance is required. Acceptance is by conduct, as where the member pays an instalment of the purchase price or renounces the allotment to another person, as where he sells his rights (***Re New Eberhardt Co ex parte Menzies*** (1889) 43 Ch D 118). Where there is a *placing* of any balance not taken up, the company's brokers offer the shares to their clients who can accept the offer.

Allotment

Authority to issue

CA 2006, ss 549–551

The CA 2006 removes for private companies the requirement for prior authorisation in certain situations (CA 2006, s 550). The CA 2006 also removes the requirement that a company's constitution have to contain a limit on the number of shares that the directors are authorised to issue.

CA 2006, s 549 states that the directors of a company must not exercise any power of the company to allot shares in the company except as provided for in CA 2006, s 550 (private company with a single class of shares) or CA 2006, s 551 (authorisation by a company). CA 2006, s 549 replaces 80(1), (2), (9) and (10) of the CA 1985. It requires that the directors not allot shares (or grant rights to subscribe for shares or to convert any security into shares) except in accordance with ss 550 and 551 respectively. Under the CA 2006, s 550, where a private company has only one class of shares, the directors may exercise any power of the company to allot shares of that class or to grant rights to subscribe for or to convert any security into such shares, except to the extent that they are prohibited from doing so by the company's articles. CA 2006, s 551 is the provision that covers authorisation by the company to allow directors power to allot shares. The directors of a company may exercise power to allot shares in the company or to grant rights to subscribe for or to convert any security into shares in the company, if they are authorised to do so by the company's articles or by resolution of the company. The special provision in the CA 1985 (s 80(2)) respecting the allotment of shares to employees remains and is now part of the CA 2006, s 549(2).

Allotments made in contravention of the above provisions will not be invalid but the directors are liable to prosecution. Furthermore, the provisions do not apply to shares taken by subscribers to the memorandum or to shares allotted as part of an employees' share scheme. If members refuse to authorise directors to allot shares, the power of allotment, except in relation to employees' shares, lies in the members themselves by ordinary resolution in general meeting. Before leaving the topic of authority to issue shares, it is worth noting that, because of the fiduciary duties which the directors owe the company, they must use the power of allotment for the 'proper purpose', which means to raise capital for the company and not, for example, to put off a takeover bid to keep themselves in control of the company.

Pre-emption rights

As regards ordinary (or equity) shareholders, the CA 2006, s 561 gives a right of pre-emption. This is designed to ensure that the rights of ordinary shareholders are not necessarily affected by the issue of further ordinary shares to others, which has never been regarded as a variation of rights. The section gives pre-emption rights to all equity shareholders in both public and private companies. Each ordinary shareholder must be offered a part of the issue pro rata to his existing holding. The offer must be in writing and delivered to the shareholders personally or by post. Equity shares may be offered to outsiders if they have not been taken up by existing shareholders within the offer period, which must be at least 21 days. Regulation 2 of The Companies (Share Capital and Acquisition by Company of its Own Shares) Regulations 2009 (SI 2009/2022) amended the minimum notice period for pre-emption rights from

21 days to 14 days. The Listing Rules were changed to reduce the minimum rights issue subscription period to 10 business days. Only when this date has expired or when the company has received a reply from every shareholder accepting or refusing the offer may the securities be allotted freely.

If CA 2006, s 561 is not complied with, the company and any officer knowingly in default is liable under the CA 2006, s 568 to compensate shareholders for their loss. Claims by shareholders must be brought within two years of the filing of the return of allotments under which the section was contravened.

A private, but not a public, company may disapply pre-emption rights *without a time limit* by a provision in the memorandum or articles stating this, or by having a provision in the memorandum or articles about pre-emption rights which is inconsistent with the statutory rules CA 2006, s 569. The pre-emption right is disapplied until such time, if any, as the memorandum or articles, as the case may be, are amended to remove the disapplication provision.

Both public and private companies may under CA 2006, ss 570 and 571 disapply pre-emption rights by a provision in the articles or by a special (or written if a private company) resolution of the members. *In either event, the maximum period for disapplication is five years or such shorter period as the articles or special resolution may state.*

Even in a private company which has given the directors a power of allotment for an indefinite period, the members must still approve the disapplication of pre-emption rights though the written resolution procedure can be used to do this. This assumes that the private company has not opted out of the pre-emption provisions altogether (see above).

The pre-emption provisions are triggered by an issue of equity shares for *cash*. Thus pre-emption rights would not apply, e.g. to an issue of preference shares for cash or to the issue of equity shares for a non-cash consideration, as in a merger of two companies where the shares in the company to be acquired are exchanged for shares in the acquiring company and the company to be acquired is then wound up following the transfer of its assets to the acquiring company. In addition, pre-emption rights do not apply where shares are allotted under an employees' scheme. Thus, if the company allots shares to employees under an employees' scheme, it is not obliged to make an offer of shares to the ordinary shareholders who are not employees. However, employees in a share scheme are entitled to participate in the pre-emption rights where an offer of equity shares is made to shareholders generally.

Thus, if a company, A, has an authorised and issued share capital of £100,000 divided into 100,000 ordinary shares of £1 each and 50,000 of those shares are held under an employees' share scheme, then on an increase of capital and a proposal to issue 50,000 additional ordinary shares, each member will be entitled to an offer to subscribe for one share for every two ordinary shares which he currently holds.

The directors must recommend the disapplication of pre-emption rights, and no special resolution to allow it or a special resolution to renew a period of disapplication previously approved may be proposed, unless with the notice of the meeting the directors have circulated a written statement giving their reasons for recommending disapplication and stating the amount which will be paid when the equity shares which are the subject of the disapplication are allotted and giving the directors' justification of that price. There are penalties for the inclusion of misleading matter in this statement.

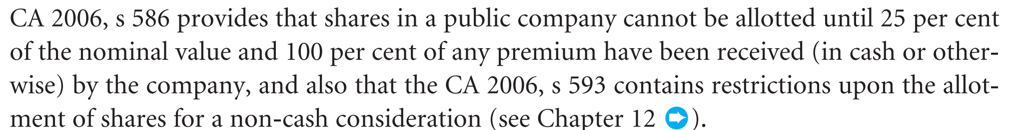
A shareholder may waive his pre-emption rights, in which case he will not be entitled to receive shares under a pre-emptive offer. In addition, shares which are offered on a pre-emptive basis may be allotted to a person in favour of whom the shareholder entitled to the offer has renounced his rights.

A copy of the resolution must be filed with the Registrar of Companies within 15 days of it being passed (ss 29–30, CA 2006).

The Registrar must under CA 2006, ss 1077 and 1078, publish a notice in the *London Gazette* of the receipt by him of a resolution passed in connection with disapplication of pre-emption rights.

It will be seen from what is said above that even when the directors have been given authority to issue shares they must still observe the pre-emption provisions outlined above.

Public companies: the 25 per cent rule



CA 2006, s 586 provides that shares in a public company cannot be allotted until 25 per cent of the nominal value and 100 per cent of any premium have been received (in cash or otherwise) by the company, and also that the CA 2006, s 593 contains restrictions upon the allotment of shares for a non-cash consideration (see Chapter 12).

See p. 243

An allottee who takes shares in a public company which are not paid up as required is liable to pay the company the balance up to the minimum the company should have received plus interest, which is at present 5 per cent per annum (CA 2006, s 592).

Allotment is usually made by the directors at a properly constituted board meeting, or by a committee of the board where the directors have power to delegate their powers to such a committee.

CA 2006, s 554 sets forth the requirements with respect to registration of allotment. In particular, such registration must take as soon as practicable but in no event later than two months after the date of the allotment. This registration requirement within two month is not applicable where the company has issued a share warrant pursuant to CA 2006, s 779.

Return of an allotment

Under CA 2006, s 555 (as under CA 1985, s 88), whenever a company makes an allotment of its shares, it must within one month of allotment deliver to the Registrar of Companies a *return of the allotments* stating the number and nominal value of the shares comprised in the allotment, the names and addresses of the allottees, and the amount paid up and unpaid on each share, whether on account of the nominal value of the share or by way of premium.

Where shares have been allotted as fully or partly paid up otherwise than in cash, as where, for example, the shares form the whole or part of the purchase price on a sale of land to the company, the consideration must be specified in the return, and if the contract is written, it must be sent with the return. If the contract is not written, a written memorandum of its terms must be made out and filed with the Registrar. These provisions are, of course, strengthened for public companies by CA 2006, s 597 (requirement to file with return of allotment an expert's report on the value of non-cash consideration) (see Chapter 12).

Compliance with these requirements is enforced by a substantial fine on every director, manager, secretary or other officer of the company who is a party to the default. The court may grant relief where the omission to deliver any document within the time prescribed is accidental or due to inadvertence or it is just and equitable to grant relief, and may make an order extending the time for the delivery of the document for such period as the court thinks proper.

Return of allotments and Companies House

CA 2006, s 555 replaces CA 1985, s 88. As under both, within one month of an allotment of new shares in a limited company, the company is required to make a return of allotments to the registrar. Such return must now be accompanied by a statement of capital which is a new requirement. CA 2006, s 556 is applicable to an unlimited company that allots shares of a class with rights not uniform with shares previously allotted.

Share certificates

The CA 2006 contains the provisions with respect to the certification and transfer of securities. Part 21 is divided into Chapters 1 (general provisions on certification and transfer of securities) and 2 (evidencing and transfer of title to securities without written certificate). Share certificates are evidence of a title (CA 2006, s 768). CA 2006, s 769 sets out responsibilities of a company as to issue of certificates on allotment. CA 2006, s 770 covers the procedure for registration of a transfer, namely, that a company may not register a transfer of shares in or debentures of a company unless a proper instrument of transfer is issued. CA 2006, s 771 provides that when a transfer of shares in or debentures of a company has been lodged with the company, the company must either register the transfer or give the transferee notice of refusal to register transfer of shares (or debentures) together with its reasons for the refusal. CA 2006, s 771 is not applicable with regard to a transfer of shares if the company has issued a share warrant in respect of the shares (CA 2006, s 779) or in relation to the transmission of shares or debentures by operation of law (CA 2006, s 771(4)(b)). CA 2006, s 771 is new and implements the recommendations of the Company Law Review. Under CA 2006, s 779 a company limited by shares may if permitted in its articles issue a share warrant stating that the bearer of the warrant is entitled to the shares specified in it.

Every company must, under the penalty of a fine for every officer of the company for each day of the default, within two months after allotment or transfer of shares or debentures have ready for delivery a certificate, unless in the case of an issue of shares the terms of the issue otherwise provide (CA 2006, s 769). CA 2006, s 741 obliges a company to register an allotment of debentures as soon as practice but in any event within two months after their allotment.

The form of the certificate is governed by the articles which may provide for the issue of share certificates under seal, though a seal is not required by law. The certificate will also specify the shares to which it relates and the amount paid up on the shares. It will be signed by at least one director and the secretary (CA 2006, s 768). If the current *Table A* applies, every certificate must be under the 'common seal' of the company especially for use on securities, if it has a seal (CA 2006, s 50(1) (restating CA 1985, s 40)). This requirement can also be found in the Model Articles for Private Companies Limited by Shares (*Article 24*) and the Model Articles for Public Companies (*Article 47*) but it can be a 'common seal' or a 'securities seal'.

Shares must be distinguished by an appropriate number, but if all the shares of the company are fully paid, or all the shares in a particular class are fully paid and rank *pari passu* in all respects, the distinguishing numbers can be dispensed with.

A share certificate under the common seal of the company or the seal kept (if any) by virtue of CA 2006, s 50(1) (restating CA 1985, s 40) specifying any shares held by any member is prima facie, but not conclusive, evidence of the title of the member to the shares.

The articles usually empower the directors to renew share certificates which have been lost or destroyed. A small fee is charged, but the shareholder must give the company an indemnity in case any liability should fall upon it by reason of the possibility of two share certificates in respect of the same holding being in existence. Where the certificate is defaced or worn out, delivery of the old certificate to the company is required.

Chapter 2 to Part 21 concerns the provisions evidencing and transferring of title to securities without written instrument. CA 2006, s 784 sets out the power of HM Treasury and Secretary of State to make regulations about transfer of title to securities without written instrument. CA 2006, s 786 provides that regulations may be made enabling members of a company or of any designated class of companies, to adopt, by ordinary resolution, arrangements under which title to securities is required to be evidenced or transferred (or both) without a written instrument.

The doctrine of estoppel

By reason of the doctrine of *estoppel* a company may be unable in certain circumstances to deny the truth of the particulars in the certificate even though they are incorrect. Once again, it will be appreciated that the law relating to estoppel presupposes the existence of a share certificate. It will be relevant mainly in private companies whose shares will not be transferred through the CREST system. It will also be relevant to those members of public companies using CREST who have opted for a share certificate which will be transferred through the company itself by sending the certificate to the company together with an instrument of transfer.

(a) Estoppel as to title

The mere fact that at some time the company has issued to X a share certificate stating that he is the holder of, say, 100 shares does not prevent the company from denying that X is the holder at some future date. The certificate is only prima facie evidence that X was entitled to the shares *at the date of issue of the certificate*.

However, if the company recognises the validity of X's title by registering or certifying a transfer to Y on the basis of the certificate, the company is estopped from denying Y's title, because it has held out to Y that X has a title.

Where the transfer is a forgery, the original transferee under it will not normally obtain a good title and the company will not normally be estopped from denying his title even if it has issued a share certificate to him. But a purchaser from the original transferee, though not getting a good title, can hold the company estopped by the certificate issued to him because he did not take it under a forged transfer, the signature of the apparent owner being on the transfer form.

Thus, if X owns some shares in a company and his clerk forges X's signature on a form of transfer and sells the shares to Y, then Y will not get a good title to the shares and the company will not be estopped by the certificate issued to him, because at this stage the share certificate is one which the company issued to the true owner, X, and the company has played no part in the deception. If, however, Y transfers the shares to Z before the forgery is discovered, and Z is issued with a share certificate, then the company will be estopped as against Z, and will have to pay him the value of the shares as damages if he chooses to sue the company rather than Y. This is because the company issued a share certificate to Y who was not the owner, thereby facilitating the deception. Nevertheless, Z will not become a member by virtue of estoppel and X's name must be restored to the register.

(b) Estoppel as to payment

In similar circumstances to those outlined above, the company may be estopped from denying that the shares are fully paid, or paid up to the extent stated on the certificate, even though the effect of this is that the shares are issued at a discount. However, the directors who issue the certificate are liable to the company for the unpaid share capital which cannot now be recovered (***Hirsche* v *Sims*** [1894] AC 654). This estoppel does not apply to a person such as an original allottee under a prospectus who knows how much he has paid up on the shares.

The doctrine of estoppel does not operate if the certificate itself is a forgery and in addition is issued by a person without apparent authority (***Ruben* v *Great Fingall Consolidated***, 1906, see Chapter 5 ➲).

➲ See p. 113

The estoppel does not seem to be defeated by the fact that the entries in the register of members show who the true owner is even though the register is accessible to the public for inspection, but there can certainly be no estoppel in favour of a person who actually knows the true facts.

Finally, there can, in general, be no claim on an estoppel without some detriment to the person making the claim. The detriment usually arises because the claimant has bought the shares or lent money on a mortgage of them. It is not normally available to a person who has received the shares as a gift.

Share warrants (or bearer shares)

Section 779 of the CA 2006 applies to the issuance of share warrants or bearer shares. A company limited by shares may issue with respect to any fully paid shares a warrant stating that the bearer of the warrant is entitled to the shares specified in it. Public and also private companies may, if authorised by their articles, issue in respect of fully paid shares a share warrant under the common seal stating that the bearer of the warrant is entitled to the shares specified in it.

Article 51 of the Model Articles for Public Companies authorises the issuance of share warrants at the discretion of the board. *Table A* does not authorise the issue of share warrants. Although share warrants could be issued under a prospectus, it has been the case in the past that they have been exchanged for registered shares and the procedures described below relate to that situation. When a share warrant is issued the company must strike out of the register of members the name of the holder of the shares and make the following entries in the register:

(a) the fact of the issue of the warrant;
(b) a statement of the shares included in the warrant, distinguishing each share by its number, if the shares had numbers; and
(c) the date of issue of the warrant.

The bearer of the warrant is, unless the articles provide to the contrary, entitled to be registered as a member on surrender of the warrant.

Difficulties arise as to the rights of holders of warrants because, although they are always shareholders, they are not members, since they are not entered on the register of members, though the bearer of a share warrant may, if the articles so provide, be *deemed* to be a member of the company either to the full extent or for any purpose defined in the articles. Their

rights are in fact governed by the articles, but *dividends* are usually obtained by handing over to the company coupons which are detachable from the warrant, the payment of dividend being advertised.

The articles may deprive the holders of share warrants of their *voting rights*, but usually they are given the right to vote if they deposit their warrants with the company, or, if the warrant is deposited at a bank, on production of a certificate from the bank. The holding of share warrants is not sufficient to satisfy a director's share qualification.

A share warrant operates as an *estoppel* that the holder has a title now, and not that he once did when the warrant was issued. Hence, *the company must recognise the holder* unless the warrant is a forgery issued by a person without apparent authority.

A share warrant is also *negotiable*, so that a title to it passes free from defects in the title of previous holders on mere delivery (***Webb, Hale & Co* v *Alexandria Water Co*** (1905) 93 LT 339).

The main advantages of share warrants are anonymity, i.e. no one can find out from the company's public records who the owner of a warrant is, and the ease of transfer. Warrants are merely handed to the purchaser avoiding the formality and expense involved in transferring a registered share. The main disadvantage is that company law leaves it entirely to the company as to how it communicates with its warrant holders. Advertisements, e.g. of meetings, may not always be seen by warrant holders who may therefore not attend and vote.

Calls

It is usual today for a company to specify in the terms of issue that money due on the shares is payable by stated instalments. These are not really calls but are contractual instalments which the member is bound to pay on the dates mentioned by virtue of taking an allotment of the shares. Where the method of instalments is used, the company cannot ask for the money sooner by relying on a general power to make calls under the articles.

A *call proper* is made in a situation where the company did not lay down a date for payment in the terms of issue of the shares. Since shares are generally fully paid up now within a short time after allotment under a fixed installment arrangement, calls are not common today.

The articles usually give the directors power to make calls subject to certain restrictions, e.g. *Table A* provides that subject to the terms of allotment, the directors may make calls upon the members in respect of any moneys unpaid on their shares (whether in respect of nominal value or premium) and each member shall (subject to receiving at least 14 days' notice specifying when and where payment is to be made) pay to the company as required by the notice the amount called on his shares. A call may be required to be paid by instalments.

A call may, before receipt by the company of any sum due thereunder, be revoked in whole or part and payment of a call may be postponed in whole or part. A person under whom a call is made shall remain liable for calls made upon him notwithstanding the subsequent transfer of the shares in respect of which the call was made. *Table A* must be complied with, otherwise there can be no action against the shareholders in respect of the call.

Table A also provides that a call shall be deemed to have been made at the time when the resolution of the directors authorising the call was passed. Joint holders of a share are jointly and severally liable to pay all calls in respect thereof.

The Model Articles for Public Companies (*Articles 54–62*) cover the procedures involved in the issuance of calls, liability of members to pay a call when asked, forfeiture procedures, etc. The directors may send a call notice to a member requiring the member to pay the company a specified sum of money (the 'call') which is payable in respect of shares which that member holds at the date when the directors decide to send the call notice. A call notice may not require a member to pay a call which exceeds the total sum unpaid on that member's shares (whether as to the share's nominal value or any amount payable to the company by way of premium); must state when and how any call to which it relates is to be paid; and may permit or require the call to be paid by instalments. A member must comply with the requirements of a call notice, but no member is obliged to pay any call before 14 days have passed since the notice was sent.

In those cases where the articles do not give the directors power to make calls, then the company may make them by ordinary resolution in general meeting. The resolution of the board or the members must state the amount of the call and the *date* on which it is payable (***Re Cawley & Co*** (1889) 42 Ch D 209). It is essential that calls be made equally on all the shareholders of the same class unless the terms of issue and the company's articles otherwise provide. *Table A* authorises such an arrangement, but that does not entitle directors to make calls on all shareholders except themselves (***Alexander* v *Automatic Telephone Co*** [1900] 2 Ch 56) unless the other shareholders *know* and *approve* of the arrangement.

An irregularity in the making of the call may make the call invalid. Any major irregularity in procedure, as where there is no quorum at the meeting, or where the directors are not properly appointed, will have that effect, although CA 2006, s 161 (replacing CA 1985, s 285) may validate the call since it provides that the acts of a director or manager shall be valid notwithstanding any defect which may afterwards be discovered in his appointment or qualification. Minor irregularities will not invalidate a call (***Shackleford, Ford & Co* v *Dangerfield*** (1868) LR 3 CP 407).

All money payable by any member to the company under the memorandum or the articles is in the nature of a *specialty debt*. This allows the company to sue for unpaid calls up to 12 years after the date upon which payment became due (Limitation Act 1980, s 8). The directors may charge interest on calls unpaid, and *Table A* provides that if a call remains unpaid after it has become due and payable, the person from whom it is due and payable shall pay interest on the amount unpaid from the day it became due and payable until it is paid at the rate fixed by the terms of allotment of the share or in the notice of the call or, if no rate is fixed, at the appropriate rate (as defined by the Companies Act and currently 5 per cent) but the directors may waive payment of the interest wholly or in part.

The company may also accept payment in advance of calls if the articles so provide. Such payments are loans, and interest is usually paid on them.

Default in payment gives the company a lien over the shares for the amount unpaid.

Table A, Regs 20–22 provide for forfeiture of shares for non-payment of a call or instalment as well as do *Articles 58–62* of the Model Articles for Public Companies.

Mortgages of shares

Mortgages of shares may be either legal or equitable.

Legal mortgages

In order that there shall be a legal mortgage, the mortgagee or lender must be entered on the register of members. To achieve this, the shares which are being used as a security must be transferred to him or his nominee. A separate agreement will set out the terms of the loan, and will also contain an undertaking by the lender to retransfer the shares to the mortgagor when the loan and interest are repaid. A legal mortgage gives the lender maximum security.

With a legal mortgage the lender (mortgagee) or his nominee is on the register and therefore appears to the outside world to be the absolute owner whereas he has a duty to transfer to the borrower on the repayment of the loan. Thus the borrower (mortgagor) should serve a 'stop notice' (see below) upon the company to prevent an unauthorised sale of the shares by the lender.

During the period that the loan is outstanding the lender will be entitled to all of the rights attaching to the shares, e.g. dividends. Because he is registered he will receive all communications from the company and is thus in a better position to reach decisions affecting the value of his security, e.g. whether to subscribe for a rights issue or cast his vote against or in favour of such important issues as reorganisation or takeover bids.

Equitable mortgages

See p. 227

Such a mortgage is more usual than a legal mortgage, particularly in the case of a short-term loan and in the case of shares in a private company where pre-emption provisions in the articles (see this chapter) may prevent the registration of the lender, and may be achieved in the following ways.

(a) Mere deposit of the share certificate with the lender

This is sufficient to create an equitable mortgage, given that the intention to do so is present, but if the lender wishes to enforce his security, he must ask the court for an *order for sale*, and having sold the shares under the order, he must account to the borrower for the balance if the proceeds exceed the amount of the loan. Alternatively, the lender can apply for an *order of foreclosure* which vests the ownership of the shares in him, and if such an order is made, the lender is not obliged to account to the borrower for any excess. For this reason foreclosure is difficult to obtain.

(b) Deposit of share certificate plus a blank transfer

Where the borrower deposits the share certificate along with a transfer form, signed by him but with the transferee's name left blank, the seller has an implied authority to sell the shares by completing the transfer in favour of a purchaser, or in favour of himself if he so wishes, and in such a case there is no need to go to the court. Once again, a separate agreement will set out the terms of the loan, and provide for the delivery of the certificate and blank transfer on repayment of the loan plus interest.

The methods of equitable mortgage outlined above do not necessarily ensure the priority of the lender as against other persons with whom the borrower may deal in respect of the shares. Where the borrower obtains another certificate from the company and sells to a *bona fide purchaser for value* who then obtains registration, that purchaser will have priority over the original lender.

It is no use in the borrower in a legal mortgage or the original lender in an equitable mortgage (L) writing to the company telling it of his interest, because by s 126 of the CA 2006, restating s 360 of the CA 1985 and Reg 5 of *Table A*, a company cannot take notice of any trust or similar right over its shares. However, a borrower or lender, as appropriate, may protect himself by serving on the company a stop notice under the Rules of the Supreme Court. He will file at the Central Office of the Supreme Court an affidavit declaring the nature of his interest in the shares, accompanied by a copy of the notice addressed to the company and signed by the applicant. Copies of the affidavit and the notice are then served on the company.

It is, however, unusual for lenders to take legal mortgages (where the shares are registered in the name of the lender or its nominee). Equitable mortgages are more common (where the lender holds the share certificate(s) and a blank, executed stock transfer form in respect of the charged shares and the shares are only registered in the name of the lender or its nominee on enforcement of the security).

Once the stop notice has been served, the company cannot register a transfer or pay a dividend, if the notice extends to dividends, without first notifying L. However, after the expiration of 14 days from the lodgement of the transfer or notice of payment of a dividend, the company is bound to make the transfer or pay the dividend unless in the meantime L has obtained an injunction from the court prohibiting it.

A judgment creditor of a registered owner of shares may obtain an order charging the shares with payment of the judgment debt. Notice of the making of the order, or demand for the dividend, when served upon the company, has a similar effect to a stop notice (see above), in that until the charging order is discharged or made absolute the company cannot allow a transfer except with the authority of the court. A charging order has no priority over a mortgage created by deposit of the share certificate and a blank transfer *before* the date on which the charging order was made.

The relevant specifics can be found at RSC Part 73, *Charging Orders, Stop Orders and Stop Notices* available at: http://www.justice.gov.uk/civil/procrules_fin/contents/parts/part73.htm#IDAEVOVB

Lien

CA 2006, s 670 provides that a lien or other charge on a company's own shares (whether taken expressly or otherwise) is void except as permitted in the section. With respect to any kind of company, a charge is permissible if the shares are not fully paid up and the charge is for an amount in respect of the shares. However, if the company is one whose ordinary business includes lending of money or consists of provision of credit or bailment, a charge is permissible if it arises in connection with a transaction entered into by the company in the ordinary course of business.

The articles often give the company a first and paramount lien over its shares for unpaid calls, or even for general debts owed to the company by shareholders, but the Stock Exchange will not give a listing where there is a lien on fully paid shares. However, a lien is permitted over partly paid shares for amounts called or payable on the shares. It is usual also for the articles to give a power of sale. *Table A* gives such a power of sale, but requires 14 days' notice in writing to the shareholder or his representatives before the sale takes place, during which

time the money owed can be paid and the sale prevented. Since on a sale the shareholder or his representatives will probably not co-operate in the necessary transfer, the articles usually provide, as *Table A* does, that a purchaser shall get a good title if the transfer is signed by a person nominated by the directors. If the articles create a lien but give no power of sale, the company would have to obtain an order for sale from the court.

A lien, other than for amounts due on the shares, cannot be enforced by forfeiture even if a power to forfeit is contained in the articles. Thus a company cannot enforce a lien for general debts by forfeiture even if its articles so provide.

The company's lien takes priority over all equitable interests in the shares, e.g. those of equitable mortgages, unless, when the shareholder becomes indebted to the company, it has actual notice of the equitable interest.

The Bradford Banking Co Ltd* v *Henry Briggs, Son & Co Ltd
(1886) 12 App Cas 29

The respondent was a trading company carrying on the business of a colliery. The articles of the company provided that it should have 'a first and permanent lien and charge available at law and in equity upon every share for all debts due from the holder thereof'. John Easby, a coal merchant, became a shareholder in the respondent company, and deposited his certificates with the bank as security for the overdraft on his current account. The bank gave notice to the company that the shares had been so deposited. Easby owed the respondent company money, having done trade with it, and he also owed money to the bank. The question for decision was whether the company was entitled to recoup its debts by exercising a lien and sale on the shares, or whether the bank was entitled to sell as mortgagees.

Held – by the House of Lords – that the respondent company could not claim priority over the bank in respect of the shares for money which became due from Easby after the notice given by the bank. The notice served by the bank was not a notice of trust under s 30 of the Companies Act 1862 (CA 1985, s 360 replaced by CA 2006, s 126), but must be regarded in the same light as notice between traders regarding their interests.

Comment

A company is not ordinarily bound to take notice of a trust or other equitable interest over its shares. It is, however, bound by such a notice when the company itself is also claiming an interest, e.g. a lien, over the shares in competition with the person who gives notice.

The lien attaches to dividends payable in respect of the shares subject to the lien (***Hague* v *Dandeson*** (1848) 2 Exch 741).

Forfeiture of shares

Shares may be forfeited by a resolution of the board of directors if, *and only if*, an express power to forfeit is given in the articles. Where such an express power exists, it must be strictly followed, otherwise the forfeiture may be annulled. The Model Article for Public Companies provides for express power to forfeit in *Article 59*. Further, the object of the forfeiture must be for the benefit of the company and not to give some personal advantage to a director or

shareholder, e.g. in order to allow him to avoid liability for the payment of calls where the shares have fallen in value as in ***Re Esparto Trading*** (1879) 12 Ch D 191.

The articles usually provide that shares may be forfeited where the member concerned does not pay a call made upon him, whether the call is in respect of the nominal value of the shares or of premium.

The usual procedure is for a notice to be served on the member asking for payment, and stating that if payment is not made by a specific date, not earlier than 14 days from the date of the notice, the shares may be forfeited. If payment is not so made, the company may forfeit the shares and make an entry of forfeiture on the register of members. Once the shares have been forfeited, the member should be required to return the share certificate or other document of title so as to obviate fraud. A forfeiture operates to reduce the company's issued capital, since it cancels the liability of the member concerned to pay for his shares in full, but even so the sanction of the court is not required; a mere power in the articles is enough.

Shares cannot be forfeited except for non-payment of calls and any provision in the articles to the contrary is void.

Reissue of forfeited shares

Forfeited shares may be reissued to a purchaser so long as the price which he pays for the shares is not less than the amount of calls due but unpaid at forfeiture.

Suppose X is the holder of 100 shares of £1 each on which 75p per share has been called up, and X does not pay the final call of 25p per share, as a result of which the shares are forfeited. If they are reissued to Y, then Y must pay not less than £25 for them, and any sum received in excess of that amount from Y will be considered as *share premium* and must be credited to a *share premium account*. Thus, although Y appears to have bought the shares at a discount, this is not so because the company has received the full amount of the called-up capital, i.e. £75 from X and £25 from Y.

The company's articles usually provide (as *Table A* does) that if any irregularity occurs in the forfeiture procedure, the person to whom the forfeited shares are reissued will nevertheless obtain a good title. This is found in *Article 61(3)* of the Model Articles for Public Companies.

Liability of person whose shares are forfeited

Forfeiture of shares means that the holder ceases to be a member of the company, but his liability in respect of the shares forfeited depends upon the articles.

(a) *Where there is no provision in the articles* with regard to liability, the former holder is discharged from liability, and no action can be brought by the company against him for calls due at the date of the forfeiture unless the company is wound up within one year of it. In such a case the former holder may be put on the *B list of contributories* in the winding-up, and may be called upon to pay the calls due at the date of the forfeiture unless they have been paid by another holder.

(b) *The articles may provide* (as does *Table A* and *Article 60* of the Model Articles for Public Companies) that the former holder shall be liable to pay the calls due but unpaid at the date of forfeiture, whether the company is in liquidation or not, unless they have been paid to the company by a subsequent holder.

Surrender of shares

The directors of a company cannot accept a surrender of shares unless the articles so provide. There is no provision in *Table A* (in contrast to *Article 62* of the Model Articles for Public Companies) but it would seem from decided cases that directors may accept surrender:

(a) where the circumstances are such that the shares could have been forfeited under the articles (*per* Lord Herschell in ***Trevor* v *Whitworth*** (1887) 12 App Cas 409); and
(b) where shares are surrendered as part of a scheme to exchange existing shares for new shares of the same nominal value, the new shares having perhaps slightly different rights and the old shares being either cancelled or available for reissue.

In other circumstances surrender is not allowed (see below).

Bellerby* v *Rowland & Marwood's SS Co Ltd [1902] 2 Ch 14

Three directors of the company, Bellerby, Moss and Marwood, agreed to surrender several of their shares to the company so that they might be reissued. The object of the surrender was not that the directors could not pay the calls, the shares being of nominal value £11 with £10 paid, but to assist the company to make good the loss of one of its ships, the *Golden Cross*, valued at £4,000. The surrender was accepted but the shares were not in fact reissued. The company survived the loss and became prosperous, and in this action the directors sought to be returned to the register as members, claiming that the earlier surrender was invalid.

Held – by the Court of Appeal – that it was invalid since the surrender was not accepted because of non-payment of calls or inability to pay them, and so the directors must be restored to the register of members.

Comment

This decision is essentially to the effect that a company cannot evade the rules relating to reduction of capital by taking a surrender of its partly paid shares.

Treatment of forfeited and surrendered shares in public companies

The above material relating to forfeiture and surrender is still valid because it relates to the source of the power to forfeit or surrender and the surrounding circumstances. However, the treatment of forfeited and surrendered shares once this has happened is a matter for the CA 2006, s 662. CA 2006, s 662 provides that no voting rights may be exercised by the company so long as the shares are forfeited or surrendered and also that the company must dispose of the shares within three years. If they are not disposed of, they must be cancelled. 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. There are, however, certain relaxations in the procedures in this event. In particular, only a directors' resolution is required to make the necessary reduction application, and any alterations to the memorandum that are necessary. The company does not need to apply to the court to obtain confirmation of the reduction in capital but any resolution passed by the directors must be filed with the Registrar. If a company fails to comply with either the requirement to cancel or the requirement to re-register as a private company, the company and its officers in default become liable to a fine.

Essay questions

1 (a) Sam has 2,000 fully paid shares in X Ltd. The articles of X Ltd give a first and paramount lien over shares in respect of any debts owed by a member to the company. On 3 January, Sam borrowed £1,500 from George and secured the loan by giving George his share certificate and a blank transfer form. George notified the company of these facts. The company informed George they could not take cognisance of his interest as this would be contrary to s 360 of the Companies Act 1985. On 10 February, Sam became indebted to the company for goods delivered to him invoiced at £800. He has not paid for these and the company seeks to enforce its lien.

Advise George of the legal position.

(b) T stole M's share certificate and forged a transfer to B, who was a bona fide purchaser. B was registered and received a new share certificate from the company. He later sold the shares to C, but T's fraud was discovered and the company refused to register C.

What is the legal position of M, C and B? (*Kingston University*)

2 Describe and discuss the significance of each of the following:

(a) The pre-emption rights of existing shareholders.

(b) Preference shares.

(c) Redeemable shares. (*The Association of Chartered Certified Accountants*)

3 Dee Ltd has an authorised and issued share capital of £15,000 in £1 shares. The directors have decided to issue for cash at par a further 10,000 £1 shares.

What procedures must the directors follow to implement their decision?

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

4 'Although they may not be in the strict sense agents or trustees for the company, promoters stand in a fiduciary relation to it.' – *Northey and Leigh*.

Discuss by looking at the promoter's relationship with the company he is forming and the remedies available for failure to discharge the fiduciary duty.

(*The Institute of Company Accountants*)

5 Explain by reference to statutory and common law examples what is meant by the term 'lifting the veil of incorporation'. (*The Chartered Institute of Management 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 The Companies Act 2006 gives shareholders a statutory right of pre-emption:

A On the allotment of any shares.
B Where shares are transferred from one member of a company to another.
C On the transmission of shares on the death of a member of the same company.
D On the allotment for cash of equity shares.

2 The board of Mersey plc has authorised the allotment of shares to the public in contravention of the statutory pre-emption rights of Mersey's shareholders. What is the legal position as regards the allotment?

A It is invalid and the allottees have no right to compensation.
B It is valid and the shareholders can ask for compensation from the directors and the company.
C It is invalid and the allottees can ask for compensation from the directors and the company.
D It is valid and the original shareholders have no right to compensation.

3 The shareholders of Test Ltd are Ann who holds 600 shares, Barbara who has 100 shares, and Clare and Diana who have 250 shares each. The shares carry one vote each. A resolution to exclude the statutory pre-emption right of the shareholders of Test Ltd, given that all members attend the meeting and that voting is by poll, requires the minimum support of:

A Ann alone.
B Ann and Barbara.
C Ann and Barbara and Clare.
D Ann and Barbara and Clare and Diana.

4 Under the provisions of the Companies Act 2006, where there is to be an allotment of unissued share capital for cash the notice of the offer to existing shareholders must remain open for not less than:

A 28 days B 21 days C 15 days D 14 days

5 Which of the following resolutions requires the directors of a private company to give a statutory declaration of solvency? A resolution to:

A Commence a creditors' voluntary winding-up.
B Reduce the company's share capital.
C Approve the giving of financial assistance for the purchase of its own shares from distributable profits.
D Approve a contract for the purchase of its own shares out of distributable profits.

6 What is the minimum percentage of shareholders required to make an application to the court to set aside an alteration of the objects clause of a company?

A Not less than 15 per cent of the total number of shareholders.
B Those holding not less than 15 per cent in nominal value of the issued share capital of the company or any class thereof.
C Not less than 15 per cent of the total number of shareholders or any class thereof.
D Those holding not less than 15 per cent in nominal value of the issued share capital of the company.

The answers to test your knowledge questions appear on p. 616.

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