(c) Where persons, as vendors, make an agreement with themselves and their nominees in the character of a limited company it is, following ***Salomon* v *Salomon & Co***, 1897, an agreement between independent legal entities and is valid.

Comment

The CA 2006, s 585 places restrictions on public companies in regard to the allotment of shares for a non-cash consideration by requiring, among other things, a valuation of that consideration. However, in private companies the company's valuation of the consideration will still be accepted as conclusive in the absence of, for example, fraud.

It should be noted, however, that the court will enquire into the agreement where the consideration does not really exist.

Hong Kong & China Gas Co Ltd* v *Glen [1914] 1 Ch 527

The company agreed that in return for a concession to supply gas to the city of Victoria, Hong Kong, it would allot the vendor of the concession 400 shares of £10 each, fully paid; and it further agreed that if and when it increased its capital in the future, the vendor or his executors, administrators or assigns should have as fully paid, one-fifth of the increased capital. In this action the company asked the court to decide whether the part of the agreement relating to the one-fifth share of any increase in the capital of the company was binding.

Held – by the High Court – it was not. The insufficiency of the consideration appeared on the face of the contract, for the company had agreed to give at any future time or times a wholly indefinite and possibly unlimited value for the purchase of the concession.

An agreement to allot shares for future services, even in a private company, may mean that the allottee will become liable to pay for the shares in full, since if he does not render the services, the company would otherwise be reduced to a mere action for damages, and would not have an action for the actual price of the shares, and it is doubtful whether a company can replace the liability of a member to pay for his shares in full with a mere action for damages (***Gardner* v *Iredale*** [1912] 1 Ch 700).

Where shares are issued for a consideration other than cash, the contract, or if the contract is not in writing written particulars of it, must be sent to the Registrar for registration within one month of the allotment of the shares. If there is no such registration within the time prescribed, the officers of the company are liable to a fine under the CA 2006, s 590, but the allotment is not affected. It should be noted that *mere registration* of a contract will not make it binding on the company if there is no consideration for it (***Re Eddystone Marine Insurance Co***, 1893, see above).

(b) In public companies

Under s 587 of the CA 2006 a public company is only allowed to allot shares as fully or partly paid by an undertaking to transfer a non-cash asset to the company if the transfer is to take place within five years of the date of the allotment.

In addition, under CA 2006, s 593 an allotment for a non-cash consideration is not to be made unless the non-cash asset has been valued by an independent accountant who would be qualified to be the auditor of the company (or by someone else approved by that independent accountant). In addition, the independent accountant must have reported to

Independent Accountants' Report issued in accordance with s 597 of the Companies Act 2006 to Dove plc

As required by s 597 of the Companies Act 2006, we report on the valuation of the consideration for the allotment to H Hawke of two hundred thousand shares of a nominal value of one pound issued at a premium of 50 pence per share. The shares and the share premium are to be treated as fully paid up.

The consideration given by H Hawke is freehold building land situated at Meadow Drift, Chelmsford, Essex. The land was valued on the basis of its open market value by R Robin, FRICS, on 1 December 2004, and, in our opinion, it is reasonable to accept that valuation. In our opinion, the method of valuation of the freehold building land was reasonable and there appears to have been no material change in the value since it was made. On the basis of this valuation, in our opinion, the value of the consideration is not less than £300,000.

Accountants & Co.

Figure 13.1 **A typical report to satisfy CA 2006, s 597**

the company on his valuation during the six months prior to the allotment, and must state that the value of the consideration is at least equal to the value of the shares being allotted. A copy of the report must also have been sent to the allottee and filed at the Companies Registry with the return of allotments (CA 2006, s 597). A typical report to satisfy s 597 appears in Figure 13.1.

A valuation of the kind set out above is not required in a share exchange as in a takeover bid where Predator is acquiring Victim by exchanging Predator shares for Victim shares so that the consideration for Predator shares is the assets of Victim, but all the holders of shares in Victim must be able to take part in the arrangement (CA 2006, s 593). The valuation is not a mere formality since failure to obtain a valuation when shares in a plc are allotted for a non-cash consideration introduces the rather startling provisions of CA 2006, s 606, i.e. that the recipient of the shares must pay for them. This is in the nature of a penalty and there are no provisions in the Act for recovery of the property. This result can be mitigated under s 606(1) which allows the recipient to apply to the court for exemption.

An exemption was granted in ***Re Ossory Estates plc*** [1988] BCLC 213 where shares were issued for a non-cash consideration, i.e. property, without an accountant's valuation. However, there was evidence before the court that the company had sold some of the properties at a profit. This suggested that they were at least as valuable as the shares issued for them and the recipient of the shares was excused from paying the cash penalty.

Under CA 2006, s 598 for two years following the date of issue of the certificate that a company registered as a public company is entitled to commence business, the company may not acquire assets from subscribers to the memorandum having an aggregate value equal to 10 per cent or more of the nominal value of the issued share capital unless:

(a) the valuation rules set out above are complied with; and
(b) the acquisition of the asset(s) and the terms of the acquisition have been approved by an ordinary resolution of the company. A copy of that resolution must be filed at the Companies Registry within 15 days of its passing.

The report under CA 2006, s 600 is similar to that under CA 2006, s 601 except that the consideration need not be shares and approval in general meeting is required.

Similar rules apply on re-registration as a public company where non-cash assets equal to at least 10 per cent of the nominal value of the issued share capital at that time are acquired from persons who are members of the company at the time of re-registration. These provisions do not apply to assets acquired in the ordinary course of business.

In addition, under CA 2006, s 584, the shares which a subscriber of the memorandum of a public company agrees in the memorandum to take must be paid up in cash, and under CA 2006, s 585 a public company must not accept at any time in payment up of its shares or any premium on them, an undertaking given by any person that he or another should do work or perform services in the future for the company or any other person.

Where the above requirements are contravened, CA 2006, s 587 provides that the allottee and his successors, but not purchasers for value without notice, will be liable to pay to the company the amount outstanding in respect of the allotment with interest which is currently 5 per cent per annum. The company and any officer in default may also be liable to a fine. However, as we have seen, the court may grant relief where the applicant has acted in good faith and it is just and equitable to grant relief.

Prohibition on allotment of shares at a discount

Companies Acts 2006, s 580 prohibits the issue of shares at a discount, though, as we have seen, this may happen in private companies where there is a *non-cash consideration* for the reason that the directors' valuation is accepted, so that there is in law no issue at a discount. A private company that issued shares for *cash at a discount* would be acting illegally. The power to pay underwriting commission under CA 2006, s 552 is not affected. Where shares are allotted in contravention of CA 2006, s 580 those shares shall be treated as paid up by the payment to the company of the amount of the nominal value of the shares less the amount of the discount, but the allottee shall be liable to pay the company the latter amount and shall be liable to pay interest thereon at the appropriate rate which is currently 5 per cent per annum (s 592). Persons who take the shares from the original allottee are jointly and severally liable with the original allottee to pay the amount mentioned above unless they are purchasers for value, and even a purchaser for value may be liable if he has actual knowledge of the contravention of s 588 at the time of the purchase.

Debentures may be issued at a discount, though where there is a right to exchange the debentures for shares at par value the debentures are good but the right to exchange is void.

Mosely* v *Koffyfontein Mines Ltd [1904] 2 Ch 108

The company proposed to issue to its shareholders certain debentures at a discount of 20 per cent, the debentures to be repayable by the company on 1 November 1909. The debenture holders were to have the right at any time prior to 1 May 1909, to exchange the debentures for fully paid shares in the company on the basis of one fully paid share of £1 nominal value for every £1 of nominal value of debentures held. The court was asked in this case to decide whether the proposed issue of debentures was void.

Held – by the Court of Appeal – it was void, because the exchange of debentures for fully paid shares would lead to the issue of shares at a discount whenever the right was exercised.

Comment

Issue of shares at a discount was permitted prior to the Companies Act 1980, but only if, amongst other things, there had been an ordinary resolution of the members, together with the permission of the court. Issue at a discount is now forbidden by CA 2006, s 552.

Shares issued at a premium

Share premiums: generally

There is nothing to prevent a company issuing shares at a premium, e.g. £1 shares at a price of £1.25p; and, indeed, where it is desired to issue further shares, of a class already dealt in on the Stock Exchange at a substantial premium, it is a practical necessity to do so except perhaps in a rights issue.

However, CA 2006, s 610 requires that such premium must be credited to a 'share premium account' to be treated as capital except in so far as it may be written down to pay up fully paid bonus shares, to write off preliminary expenses, commissions and discounts in respect of new issues, and to provide any premium on the redemption of any debentures. It may also be used in a very restricted way to charge the premium on redemption of shares if this premium has been paid out of the proceeds of a fresh issue of shares made for the purpose.

The above rules prevent such premiums which are capital by nature from being paid away as dividends. Any balance on the share premium account must be shown in the balance sheet.

Section 610 in fact recognises that the real capital of a company is the price which subscribers pay for its shares and not the somewhat artificial nominal value. This results, in effect, in an admission that shares are really of no par value. If no par value shares were issued, the capital of the company would simply be the total paid for its shares by subscribers. This is known in the United States as the company's paid-in capital. Where the whole of the issued price has not been paid, the total amount paid plus the total amount remaining to be paid is in the United States called the company's stated capital.

If it were possible to issue no par shares in England, the accidental payment of dividends out of capital would automatically be precluded by the company's obligation to keep in hand assets worth at least the amount paid by subscribers plus the amount of the company's outstanding debts. However, until no par value shares are allowed, the law can ensure that the issue price of the shares is not dissipated in paying dividends only by using the somewhat inelegant device of the share premium account.

The Companies Act 2006 requires share premiums to be credited to a share premium account whether the shares are issued for cash or otherwise. In consequence, the Act always applies whether premiums are paid in cash or kind and so if a company issues shares for a consideration in kind which is worth more than the nominal value of the shares, a sum equal to the excess value of the consideration has to be transferred to a share premium account.

Henry Head & Co Ltd v Ropner Holdings Ltd [1952] Ch 124

Ropner Holdings was formed as a holding company, its main object being to acquire the whole of the issued share capital of the Pool Shipping Co Ltd and the Ropner Shipping Co Ltd for the purposes of amalgamation. Ropner Holdings issued the whole of its authorised capital of £1,759,606 (this being equal to the sum of the issued capitals of the two shipping companies) to the shareholders of Pool Shipping and Ropner Shipping on the basis of £1 share for each £1 share held in the two shipping companies. The value of the assets of the two shipping companies, when Ropner Holdings acquired the shares, was £6,830,972, and the difference between this figure and £1,759,606, less formation expenses, was shown on the balance sheet of Ropner Holdings as 'Capital Reserve – Share Premium Account' so as to comply with the Companies Act 1948. The claimants, who were large shareholders in Ropner Holdings, asked that the company be required to treat the reserve as a general and not a capital reserve because otherwise no payment out of the reserve could be made unless the procedure for reduction of capital was followed.

Held – by Harman J – Ropner Holdings had, in effect, issued its shares at a premium within the meaning of what is now s 130, and was bound to retain the reserve as a capital reserve.

Comment

The case is still authority for the statement that a share premium account must be raised even where the consideration is not cash. However, in the circumstances of the case merger relief would presumably have been available.

Share premiums – acquisitions, mergers and group reconstructions

Companies Acts 2006, ss 611–615 give relief, in certain circumstances, from the requirement to set up a share premium account under s 610.

Acquisitions and mergers

(a) Acquisitions. This involves a takeover where the predator company P makes an offer to the shareholders of the Victim company V either with or without the consent of the board of V. The price offered is usually above the market price. If V is acquired, i.e. if there are sufficient acceptances from the shareholders of V, the investment of P in V must be shown in the books of P at its *true value*, i.e. the value of the consideration given. This has the effect of treating the reserves of V as pre-acquisition and therefore as undistributable and in particular pre-acquisition profits are locked up.

This position is unchanged by the CA 2006 and pre-acquisition profits must be locked up because if V pays a dividend to P out of pre-acquisition profits and P uses it to pay dividend to its shareholders P is returning the capital it used for the purchase of V's shares to its members because the pre-acquisition profits were represented in the price which P paid for V's shares.

(b) Mergers. In the case of a merger between P and V involving a share-for-share exchange, e.g. P issues its equity shares to the members of V on a one-for-one basis, in exchange for the shares of the members of V, as a result of which P becomes the holder of 90 per cent or more of the equity shares of V, then there is no need to value the investment in V at its true value. The value may simply be the nominal value of the shares exchanged and so no share premium account is created as was the case in ***Henry Head*** under the old law (see above). Thus, the reserves of V need not be treated as pre-acquisition and pre-acquisition profits are not locked up.

Section 613 sets out the minimum conditions which must be met before a company can use the merger method of accounting. The conditions are:

1 The parent company must acquire at least 90 per cent by nominal value of relevant shares in the target company. This is then a genuine 'pooling of assets'. Relevant shares are shares carrying unrestricted rights to participate both in distributions and in the assets of the undertaking on liquidation.
2 The 90 per cent must be achieved under an arrangement for the issue of shares by the parent company, i.e. merger accounting is appropriate only where there is substantially a share-for-share exchange. It is permissible to have a prior holding but the 2006 Act does not restrict its size.
3 The issue of equity shares must be the dominant element in the consideration offered by the parent company for the relevant shares in the company to be acquired. The fair value of the consideration which may be given in a form other than equity shares is limited to 10 per cent of the nominal value of the equity shares issued.
4 Finally, merger accounting is not available as of right even if (**1**)–(**3**) are satisfied but only where its use accords with generally accepted accounting principles and practice.

Students who are also taking accounting courses will appreciate that this area of the law is subject to Accounting Standards issued by the Accounting Standards Board. It would not be appropriate to deal with these here and an examination in company law would not require knowledge of them. They would normally be examined in accounting papers.

However some of them are so important that they have a major effect on statutory provisions and must be noted in outline here. Corporate mergers will in regard to business combinations agreed on or after 31 March 2004 always be treated as if one party is buying the other (an acquisition) under amendments to International Accounting Standard 36 issued by the International Accounting Standards Board. As already noted merger accounting enables the enlarged group to take a full year of profits from both companies. Under the amended IAS 36, companies will have to treat mergers as takeovers so the enlarged organisation can only count profits since the date of acquisition (acquisition accounting).

The need to write down goodwill following a takeover is abolished. In future all goodwill is to be valued according to the profits that are actually earned from the business and projected to be earned in the future.

Group reconstructions

Companies Acts 2006, s 611 provides limited relief in the case of certain group reconstructions. The reconstructions to which the CA 2006 applies are those where the transactions are as follows:

(a) a wholly-owned subsidiary (the issuing company) has allotted some of its shares either to its holding company or to another wholly-owned subsidiary of its holding company;
(b) the allotment is a consideration for the transfer to it of shares or any non-cash assets in another subsidiary of the holding company. This other subsidiary need not necessarily be wholly owned.

The purposes of reconstruction and the variety of changes that can be achieved by the use of the reconstruction sections of the CA 2006 are further described in Chapter 24.

However, let us assume that our holding company (H) holds 100 per cent of the shares in company A and 75 per cent of the shares in company B. A allots 1,000 £1 ordinary shares (valued at £6 per share) to H; in return H transfers its 75 per cent holding in B to A. If there was no relief in this situation, A would have had to raise a share premium account in its books. However, under s 611(2) A need only transfer to a share premium account an amount equal to the 'minimum premium value'.

This is the amount, if any, by which the base value of the shares in the subsidiary (B) exceeds the aggregate nominal value of the shares that the issuing company (A) allotted in consideration for the transfer.

Base value is the lower of

(a) the cost to the holding company (H) of the shares in B;
(b) the amount at which the shares of B were stated immediately prior to this transfer in the accounting records of H.

Thus, if in our example the shares in B cost £4,000 but are standing in the accounting records of H at £3,000 the base value is £3,000. The nominal value of the shares allotted by A is £1,000 so the minimum premium value is £2,000 and this must be transferred to A's share premium account, but not, of course, the true value of the consideration it received from B by allotting 1,000 shares to H.

Finally, it should be noted that the CA 2006 imposes no obligation on a company to issue its shares at a premium when a premium could be obtained. Consequently, the issue of shares at par is valid even though a premium could have been obtained (***Hilder* v *Dexter*** [1902] AC 474) but directors who fail to require subscribers to pay a premium which could have been obtained are guilty of breach of duty to the company and will be liable to pay the premium themselves as damages (***Lowry* v *Consolidated African Selection Trust Ltd*** [1940] 2 All ER 545). Nevertheless, there are some exceptions to this ruling. For example, directors may issue shares at a price below their market value to existing shareholders in pursuance of a rights offer made to all the shareholders of the company, or to all the ordinary shareholders in proportion to the nominal values of their existing holdings. The reason for this is that all the shareholders concerned can avail themselves of the offer and if they do none of them will suffer a diminution of their percentage interest in the net assets or earnings of the company and consequently none of them will be harmed.

Insider dealing

Part V of the Criminal Justice Act 1993 applies and Sch 2 to that Act sets out the securities covered by its provisions. It is not necessary at this level to list all of these, but obviously shares issued by companies are covered, and the prosecutions that have been brought under the insider-dealing rules, which are very few, have been concerned with dealings in company shares. However, the 1993 Act also covers gilts, which are interest-bearing securities as distinct from shares which pay a dividend, and where insider dealing could consist of dealing in such securities with inside information as to changes in interest rates either up or down.

The securities must also be listed on a regulated market such as the Stock Exchange, but dealing in differences is covered too. Those who deal in differences do not buy shares or even take an option on them. The deal consists of a forecast of the price of a particular security at a given future time, and those who enter into such deals with inside information which helps them better to predict the price will commit an offence.

See p. 385

The Act does not apply to unlisted securities or face-to-face transactions, so that cases such as ***Percival* v *Wright***, 1902 (see Chapter 19) are unaltered on their own facts.

Meaning of dealing

A person deals in securities if he acquires or disposes of the securities himself, whether for himself or as the agent of some other person, *or* procures an acquisition or a disposal of the securities by someone else. Therefore, A could acquire shares for himself, or acquire shares as a broker for his client or dispose of them in the same contexts. Alternatively, A may simply advise B to purchase or dispose of shares and still be potentially liable if he has inside information. B may also be liable in this situation if he is a tippee (see below).

What is inside information?

Basically, this is information which relates to the securities themselves or to the state of the company which issued them. It must be specific and precise so that general information about a company, e.g. that it was desirous of moving into the field of supermarkets, would not be enough. In addition the information must not have been made public and must be the sort of information which, if it had been made public, would be likely to have had a significant effect on the price of those securities, e.g. falling or rising profits or decisions to pay a higher dividend than expected, or a lower one or no dividend at all.

Insiders

In order to be guilty of the offence of insider dealing, the individual concerned must be an insider. A person has information as an insider if:

- the information which he has is and he knows it is 'insider information';
- he has the information and he knows that he has it from an 'inside source'.

A person is in possession of information from an 'inside source' if:

- he has the information through being a director, employee or shareholder of a company or by having access to it by reason of his employment, e.g. as auditor; or
- the source of the information is a person within the above categories.

So A is a director of Boxo plc. He has inside information that Boxo's profits when announced in ten days' time will be up (or down). He buys (or sells) Boxo shares himself and is potentially liable. He advises his friend Fred to buy (or sell) Boxo shares but does not tell him why. A is potentially liable but Fred is not – he does not have the inside information. If A tells Fred about the future profit announcement and then Fred deals, Fred is potentially liable, as is A. If Fred advises his son to buy (or sell) Boxo shares but does not tell him why, A and Fred are potentially liable but Fred's son is not. If Fred gives his son the inside information and the son deals, then A and Fred and Fred's son are potentially liable.

Disclosure in the course of employment

Sometimes it is necessary for a person to pass on inside information as part of his employment, as may be the case with an audit manager who passes on inside information to a senior partner of the firm who is in charge of the audit. If the senior partner deals he will be potentially liable, but the audit manager will not since the 1993 Act exempts such persons.

Necessity for intent

Since insider dealing is a crime, it requires, as most but not all crimes do, an intention to see a dealing take place to secure a profit or prevent a loss. It is unlikely that an examiner would go deeply into what is essentially the field of the criminal lawyer, but consider this example: A's son was at college and broke. He asked his father for a loan and his father said, 'Look, son, you're not getting any more money from me – pity you cannot buy some shares in Boxo plc of which I am a director. Next month's profit announcement will be way up on last year's. You could make a killing.' If for some reason A's son was able to scrape up sufficient funds to buy shares in Boxo plc, it is unlikely that his father would be liable because he had no idea that his son would be in a position to buy the shares.

Penalty for insider dealing

The contract is unaffected as in ***Percival* v *Wright***, 1902. The sanctions are criminal, the maximum sentence being seven years' imprisonment and/or a fine of unlimited amount. In order to be found guilty, the offence must in general terms be committed while the person concerned was in the UK or the trading market was.

Exemptions

Schedule 2 to the Criminal Justice Act 1993 sets out in particular an exemption for persons operating as market makers, so that, for example, those engaged in making a market for shares on the Stock Exchange are exempt because they would find it difficult to operate markets in shares if they had to stop dealing in them when in possession of what might be inside information about some of them. It should be noted, however, that the exemption covers only the offence of dealing. They are not exempt from the offence of encouraging another to deal.

Market abuse

The Financial Services and Markets Act 2000 introduces the concept of market abuse. Under the relevant provisions, the Financial Services Authority has power to reprimand publicly or impose an unlimited fine on authorised and unauthorised persons for engaging in market abuse. The Financial Services Authority is the sole regulator for the financial services industry and has the power to authorise persons and organisations to operate in it. Its power extends to non-authorised persons and this would include members of professions such as lawyers and accountants who are, for example, authorised by their own professional bodies to give advice incidentally to the practise of their profession, as where an accountant gives a client advice on investments as part of a tax-planning arrangement. Such persons are not authorised by the FSA unless investment advice is their main line of business and yet are covered by the market-abuse rules. Indirect market abuse is covered as where a person requires or encourages another to engage in behaviour that if done by the defendant would amount to market abuse (s 123(1) and (3)).

Market abuse defined

Section 118(1) defines market abuse as:

- behaviour in relation to any qualifying investments;
- likely to be regarded by regular users of the market as falling below the standard reasonably expected of a person in that position; and
- that falls within at least one of three categories (see below).

In general terms, the behaviour will be in a UK investment market, such as the London Stock Exchange. The regular-user concept is hypothetical and is defined as 'a reasonable person who regularly deals on the market in investments of the kind in question' (s 118(10)). The behaviour referred to is set out in s 118(2) as:

- based on information not generally available to users of the market which, if available to a regular user, would be likely to be regarded by him as relevant in regard to the terms on which to deal in those investments. *In other words, insider information*;
- likely to give a regular user a false or misleading impression as to the market value of such investments. *In other words, misleading statements and practices*; or
- regarded by a regular user as likely to distort the market in such investments. *In other words, rigging the market*, as where a company makes funds available to a person so that he can buy its shares in order to raise the market price by increased demand so that the shares will be more acceptable as part of takeover consideration by an exchange of shares.

There is a major defence that the person concerned exercised all due diligence to avoid market abuse, and there is a 'safe haven' where the Takeover Panel has ruled that the dealing may go ahead, as where a person with inside knowledge deals as part of a rescue operation to save the company concerned.

The market code

The FSMA gives only a broad definition of abuse but the FSA has drawn up, as the Act requires, a Code of Market Conduct to help particularise abuse. For example, the Code mentions persons using Internet bulletin boards to post misleading information and journalists using inside knowledge to trade in shares.

Burden of proof

Unlike the provisions of the Criminal Justice Act 1993, which are obviously criminal in nature and where proof beyond a reasonable doubt is required (this being the cause of its failure to provide convictions in many cases), the FSA operates under *a civil regime* so that abuse need be proved only on a balance of probabilities. However, because the proceedings might be viewed as criminal in nature under the Convention on Human Rights, the government has excluded the admission of compelled evidence emanating, for example, from a BIS inspection. It has also granted safe harbours and a due diligence defence under the Code and made some legal aid available (ss 114(8), 122, 123(2), 134–136 and 174(2)).

Injunctions and restitution

In order not to disturb the proper working of the market when the FSA imposes a fine, the transaction is not made void or unenforceable. However, for any form of market abuse or misconduct, the FSA can seek to prevent anticipated abuse by a court injunction and ask the court for a restitution order on behalf of victims of abuse to make up their loss. There are defences of reasonable belief and due diligence (ss 382(1) and (8); 383(1), (3) and (10); and 384(1) and (6)).

Position of the Criminal Justice Act 1993

This measure is not repealed and continues to be available for the pursuit of criminal prosecutions.

Model Code for Securities Transactions by directors of listed companies

The Financial Services Authority set up a Model Code for Securities Transactions, to give guidance as to when it is proper for directors of listed companies to deal in the securities of the company. The Code received widespread acceptance and is part of the Listing Rules. The main principles of the Code are:

(a) Directors should not engage in short-term dealings, e.g. purchases and sales over short periods, because it is difficult to avoid the suggestion that such dealing is based on inside knowledge.

(b) Directors should not deal for a minimum period prior to the announcement of reports and results. Where results are announced half-yearly, the closed period for dealings should be the previous two months but, if announcements are more frequent, e.g. quarterly, the period is one month immediately preceding the announcement of the quarterly results.

Directors should not deal either when an exceptional announcement is to be made which would probably affect the market price of the company's shares, or when they are in possession of knowledge which when accessible to the public will affect the market price of the shares.

(c) A director must obtain clearance from the chairman (or other designated director) before dealing. The chairman must obtain clearance either from the board or the designated director before dealing. Clearance must not be given in a closed period.

(d) A written record of dealings should be kept by the company and the board as a whole should see that directors comply with a practice to be established within the company on the above lines. In this respect a director should ensure that where he is a beneficiary under a trust, the trustees notify him after dealing so that it can be recorded. In addition, a director must return dealings of a spouse or for minor children.

The above rules apply also to 'relevant employees', i.e. those whose work within the company may cause them to be in possession of price-sensitive information in regard to its securities and to dealings by a director's 'connected' person, e.g. a spouse.

Full details of the Model Code appear in the Listing Rules (the 'Purple Book') as an appendix to Chapter 16 of those rules.

Essay questions

1 Give an account of the statutory restrictions which seek to ensure that when shares are issued by a company, they are paid for either in money or in money's worth. (*Napier University*)

2 'A survey of price movements . . . showed clearly that there was a general tendency for the price of shares in bid-for companies to rise sharply before the announcement of takeover bids, which is in itself *prima facie* evidence of "inside buying". And there has been a continuing series of cases in which specific allegations of improper conduct by insiders have been made. The question of control over insider trading has consequently been a matter of general concern in recent years.' (Hadden)

How far has legislation alleviated this concern? (*University of Central Lancashire*)

3 (a) Druid Ltd has recently issued an additional one thousand shares. Five hundred of these were issued to its former employee, Edwin, in return for his past services and his agreement not to set up a competing business in the same locality. The other 500 were issued to Francis in return for the use for a year of his garage as storage space. Previously, Francis had let his garage for this purpose for £100 per annum.

Discuss. How would your answer be different if Druid Ltd had been a public company?

(b) Gorgon Ltd has an issued share capital of £2 million. In 1999 it made a trading profit of £100,000 but the value of its assets fell to £1 million. In 1998, it made a trading loss of £50,000.

Advise the directors whether, and how much of, the 1999 profit is available for distribution as dividend. How would your answer differ if Gorgon Ltd was a public company?

(*The Institute of Chartered Secretaries and Administrators*)

4 (a) Explain what is meant by the term 'capital maintenance'.

(b) Discuss how the provisions of the Companies Act 2006 attempt to ensure capital maintenance by regulating:

(i) the payment of dividends,

(ii) the issue of shares at a premium.

(*The Chartered Institute of Management Accountants*)

5 Who is an 'insider' and what is 'inside information' for the purposes of the laws relating to insider dealing? What prohibitions are imposed on the activities of insiders? State the main exemptions to these prohibitions. (*Author's question*)

6 James agrees to pay £2m for a controlling interest in Sapphire plc providing the company transfers £3m deposited with its present bankers to Emerald Bank from which James has arranged to borrow £2m. After the transfer Emerald Bank honours the cheque drawn by James to pay for the shares in Sapphire plc.

Discuss the legality of the above transactions.

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

7 Rich and Wealthy are partners in a firm which they wish to convert into a limited company, but they are undecided between incorporating with private status or public status. Advise them as to the advantages and restrictions of each type of company.

(*The Institute of Company 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 Boxo plc was formed five years ago. It now proposes to issue 100,000 shares of £1 each to Alan in return for freehold land in Barchester. In order that the transaction should conform with company law:

A There must be a valuation of the land by the company's auditor.
B There must be a valuation by the company's auditor but only if the land is estimated to be worth more than 10 per cent of the company's issued share capital.
C There must be a valuation by an independent accountant qualified to be the company's auditor, regardless of the estimated value of the land.
D No valuation is required.

2 Which of the following is a permissible use of the share premium account under s 130 of the Companies Act 2006?

A Writing off a premium on redemption of any ordinary shares.
B Writing off goodwill.
C Writing off a premium on the redemption of debentures.
D Writing off a deficit on the profit and loss account.

3 Trent plc has issued convertible debentures to Bill at a discount. The legal position is:

A the issue is valid but the right to convert to shares is void.
B the issue is valid and so is the right to convert to shares.
C the issue is void and so therefore is the right to convert to shares.
D the issue is valid and so is the right to convert to shares if the members of Trent agree by ordinary resolution.

4 John is a director of Derwent plc, a listed company. The board of Derwent received at its last meeting a report by Joe, the finance director of Derwent, that Derwent's profits would be up by 30 per cent and that this would appear in the press report of the annual results in two weeks' time. Next day John told Sid his golfing companion that Derwent's profits would be 30 per cent up and Sid bought shares in Derwent. On the same day Sid said to his son Ronald, who was a well-paid consultant engineer, that he 'really ought to have some shares in Derwent because

they seem to be a good thing'. Ronald also bought shares in Derwent. When the results were announced the shares in Derwent increased in price by 0.5p per share. Which of the following statements represents the legal liability of the parties?

- **A** Only John is liable.
- **B** John and Sid are liable.
- **C** John and Joe are liable.
- **D** John, Joe and Ronald are liable.

5 George, who is a creditor of Tees Ltd, can object to the court, regardless of the amount of his debt, about a resolution of the company which has the effect of:

- **A** Writing off goodwill against the share premium account.
- **B** Repaying debenture holders.
- **C** Writing off a deficit on profit and loss account to share capital.
- **D** Repaying non-redeemable share capital.

6 George, a director and member, proposes to transfer his shares in Moorgate Ltd in breach of a pre-emption clause in the articles of Moorgate which provides that members will offer their shares to other members first and that the other members may purchase them. What action can the other shareholders take?

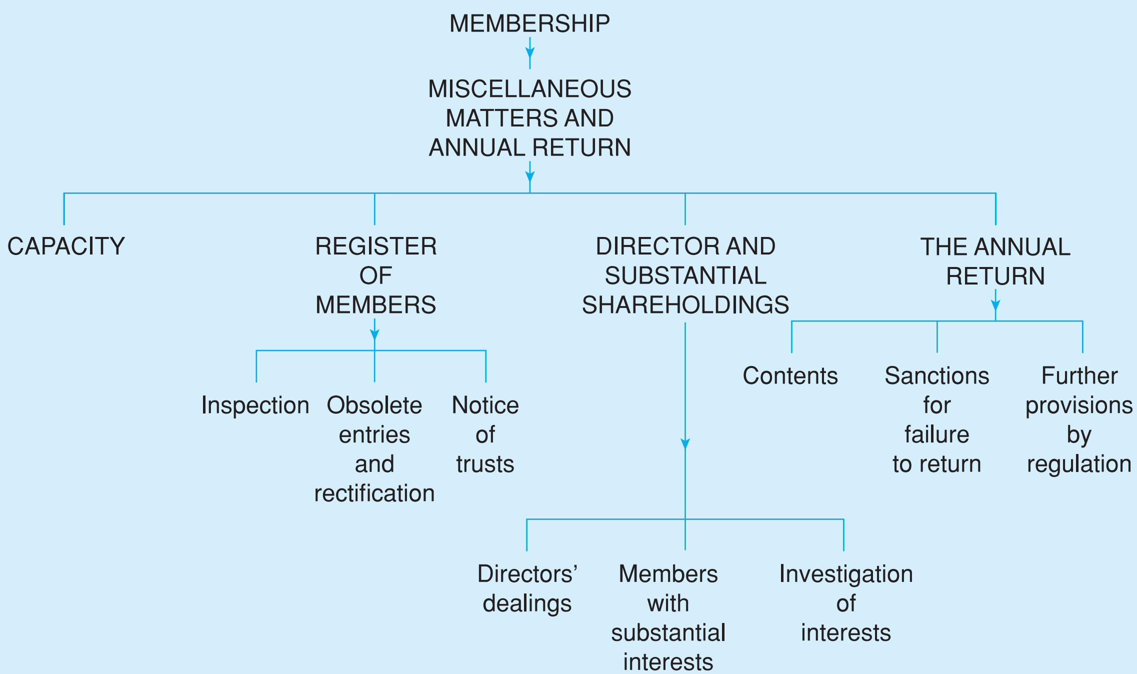
- **A** Restrain the transfer through an action by the company.
- **B** Bring an action against George through the company for breach of his fiduciary duties as a director.
- **C** Bring a personal action to prevent the transfer as being in breach of contract.
- **D** They can take no action.

The 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.

mylawchamber
unrivalled support for legal education

14 Membership – capacity, registration, director and substantial holdings, annual return



There are several ways in which membership of a company may be acquired. These are as follows:

(a) *By subscribing the memorandum*. When the company is registered, the persons who subscribed the memorandum automatically become members on subscription, and must be put on the register of members on registration of the company (s 112(1), Companies Act 2006).
(b) *By making an application* on the basis of listing particulars or a prospectus for an allotment of shares.
(c) *By taking a transfer* from an existing member.
(d) By succeeding to shares on the death or bankruptcy of a member.

The persons mentioned in (b), (c) and (d) above do not actually become members until their names are entered in the register of members. In this regard CA 2006, s 122(2) states that every other person who agrees to become a member of a company, and whose name is entered in its register of members, is a member of the company.

Capacity

The question of capacity is governed by the general law of contract, and anyone who has the capacity to make a contract may become a member of a company. The contracts of minors are governed by rules of the common law some of which have been enacted, e.g. in the Sale of Goods Act 1979 as amended by the Minor's Contracts Act 1987. The position as regards company membership appears below.

A minor may be a member of a company unless the articles otherwise provide. Registration of a minor may give rise to difficulties in the case of partly paid shares or unlimited companies, because a minor can repudiate the contract with the company at any time during minority and for a reasonable time thereafter. If he does repudiate, he cannot recover the money he has paid up to the time of repudiation if the shares have ever had any value.

Steinberg* v *Scala (Leeds) Ltd [1923] 2 Ch 452

The claimant, Miss Steinberg, purchased shares in the defendant company and paid certain sums of money on application, on allotment and on one call. Being unable to meet future calls, she repudiated the contract while still a minor and claimed:

(a) rectification of the register of members to remove her name therefrom, thus relieving her from liability on future calls; and
(b) the recovery of the money already paid.

The company agreed to rectify the register and issue was joined on the claim to recover the money paid.

Held – the claim under (b) above failed because there had not been total failure of consideration. The shares had some value and gave some rights even though the claimant had not received any dividends and the shares had always stood at a discount on the market.

The Family Law Reform Act 1969, s 1 reduced the age of majority from 21 to 18 years. There is a general provision in the Act that a person attains a particular age, i.e. not only the age of majority, on the first moment of the relevant birthday.

A company always has power to refuse to accept a minor as a transferee or shareholder where it knows his age and can probably set aside a transfer to a minor once it learns the position (***Re Contract Corporation, Gooch's Case*** (1872) LR 8 Ch App 266). However, if a company registers a minor knowing him to be such it cannot afterwards repudiate him.

The register of members

Section 113(1) requires every company to keep a register of its members. The register must contain the following information:

(a) the names and addresses of the members (s 113(2)(a));
(b) the date on which each person was entered in the register as a member (s 113(2)(b));
(c) the date on which each person ceased to be a member (s 113(2)(c)).

Section 113(3) goes on to state that in the case of a company having a share capital there must be entered in the register, with the names and addresses of the members, a statement of:

(a) the shares held by each member, distinguishing each share
  (i) by its number if it has one; and
  (ii) where the company has more than one class of issued shares, by its class, and
(b) the amount paid or agreed to be considered as paid up on the shares of each member (s 113(3)(b)).

Section 113(4) states that if the company has converted any of its shares into stock, and given notice of the conversion to the registrar, the register of members must show the amount and class of stock held by each member instead of the amount of shares and the particulars relating to shares.

In the event of joint holders of shares or stock in a company, the company's register of members must, according to s 113(5), state the names of each joint holder.

Failure to keep a register of members renders the company and every officer in default liable to a fine and also to a daily fine for each day during which the default continues (s 113(7)(8)).

The register may be kept in any form, e.g. in the form of a loose leaf system, so long as proper precautions are taken to guard against falsification. The 2006 Act allows the use of computers for company records, including the register of members, so long as the records can be reproduced in legible form. According to s 115, a company with more than 50 members must keep an index of its members, and if there is any alteration in the register, the index must also be altered within 14 days of such alteration (s 115(2)). The above provisions do not apply if the register is kept in the form of an index (s 115(1)). Section 115(4) outlines the fact that the index must be at all times kept available for inspection at the same place as the register of members.

Section 114(1)(a) states that the register and index must be kept available for inspection at the registered office of the company, or at a place specified in regulations under s 113(6) of the CA 2006. Section 114(2) goes on to note that a company must give notice to the Registrar of the whereabouts of the register and of any changes in that place. If a company makes default for 14 days in complying with this requirement, then s 114(5) states that an offence is committed by the company and every officer of the company who is in default. However, s 114(3) states that no such notice is required if the register has, at all times since it came into existence, been kept available for inspection at the company's registered office.

Inspection of register

During business hours the register and the index must under s 116 of the CA 2006 be kept open for inspection by any member free of charge (s 116(1)(a)), and by any other person on payment of a fee (s 116(1)(b)). Under s 116(2), the company must make available either to a member or to any other person a copy of any part of the register, and may make a charge for this. The company must either send the copy (s 117(1)(a)) or apply to the court (s 117(1)(b)) within five days of receiving a s 116 request.

If a company makes an application to the court and the court is satisfied that the inspection or copy is not sought for a proper purposes, then it shall direct the company not to comply with the request (s 117(3)(a)), and it may order that the company's costs on the application be paid in whole or in part by the person who made the request (s 117(3)(b)). Indeed, s 119(1) states that it is an offence for a person to knowingly or recklessly to make in a request under s 116 a statement that is misleading, false or deceptive in a material particular. This gives the court a discretion and it may refuse to make an order, e.g. in the case of a pro-hunting charity which felt that a disclosure of members might be detrimental. A compromise might be achieved by the company offering to act as a post-box for confidential communication to and from members (see ***P* v *F Ltd*** [2001] NLJR 284). The Court of Appeal accepted a similar post-box undertaking from a company and refused to make an order for inspection in ***Pelling* v *Families Need Fathers Ltd*** [2002] 2 All ER 440 where the defendant company was a charity with the object of helping parents to stay in touch with their children after separation or divorce.

If on application under s 117(1)(b), the court does not direct the company not to comply with the s 116 request, the company must comply with the request immediately upon the court giving its decision (s 117(5)).

According to s 119(2), it is an offence for a person in possession of information obtained by exercise of either of the rights conferred by s 116 to do anything that results in the information being disclosed to another person, or to fail to do anything with the result that the information is disclosed to another person, knowing or having reason to suspect that person may use the information for a purpose that is not a proper purpose.

The right of inspection terminates on the commencement of winding-up (***Re Kent Coalfields Syndicate*** [1898] 1 QB 754). Any rights then existing are derived from the insolvency rules, and not from the Act, and may require an order of court.

Obsolete entries in the register

Section 121 states that a company may remove from the register any entry which relates to a former member where the person concerned has not been a member for at least 10 years.

Rectification of the register

The register of members is under s 127 prima facie evidence of the matters which the Companies Act requires it to contain.

However, the court has power under s 125 to rectify the register if application is made to it where:

(a) the name of any person is without sufficient cause entered in or omitted from the register; or
(b) default is made, or unnecessary delay takes place, in entering on the register the fact that a person has ceased to be a member.

As well as rectification, the court may order the payment by the company of any damages sustained by any party aggrieved (s 125(2)). Notice of rectification must be given to the Registrar of Companies under the terms of the court's order (s 125(4)).

The circumstances set out in (a) and (b) above are not the only ones in which the court can order rectification. For example, rectification will be ordered where joint holders wish to split the holding because in general terms the rights attaching to the shares, e.g. voting rights, are vested in the first-named person on the register (see below). The company should therefore in ordinary circumstances agree to a request to split the holding.

Burns* v *Siemens Bros Dynamo Works Ltd [1919] 1 Ch 225

The claimants, Burns and Hambro, were the joint owners of shares in the defendant company. The shares were entered in the company's register in the joint names of Burns and Hambro. The company's articles provided that, where there were joint holders, the person whose name appeared first in the register of members, and no other, should be entitled to vote in respect of the shares. The result was, of course, that Hambro had no voting rights. This action was brought by Burns and Hambro asking that the register be rectified so as to show roughly half of the joint shareholding in the name of each joint holder.

Held – by the High Court – the court had jurisdiction to make such an order, and the company was required to rectify the register, showing shares numbered 1 to 10,000 in the names of Burns and Hambro, and shares numbered 10,001 to 19,993 in the names of Hambro and Burns.

Comment

Rectification will also be granted where an allotment of shares is set aside following, for example, a false statement in a prospectus. The consequent action for rescission – if that is the course the claimant chooses to pursue – is accompanied by a request for rectification of the register.

Notice of trusts

Under s 126 of the Companies Act 2006, no notice of any trust shall be entered on the register of members of companies registered in England and Wales. The rule laid down by the section has two branches:

(a) *The company is entitled to treat every person whose name appears on the register as the beneficial owner of the shares even though he may in fact hold them in trust for another.* Thus, if the company registers a transfer of shares held by a trustee, it is not liable to the beneficiaries under the trust even though the sale of the shares by the trustee was fraudulent or in breach of the powers given to him in the trust instrument.

Simpson* v *Molson's Bank [1895] AC 270

This was an appeal to the Privy Council in England from the Court of Queen's Bench for Lower Canada. It appeared that the bank was incorporated by an Act of Parliament, and that by s 36 of that Act the bank was not bound to take notice of any trust over its shares. (The provision was similar to the one contained in s 360.) The executors of the Hon John Molson were given 10 years by his will to wind up his estate. After the expiration of that time, and in breach of the terms of the will, they made a transfer of certain shares in the bank. The claimants, who had an interest in the residuary estate of John Molson, brought this action claiming damages from the bank because it had registered a transfer knowing that transfer to be in breach of trust, such knowledge being derived from the fact that a copy of the will was deposited at the bank, and that William Molson, the testator's brother, was one of the executors who signed the transfer and was also the president of the bank.

Held – the bank was not liable for registering the transfer although it had notice that it was in breach of trust, because s 36 of the Act of Parliament incorporating the bank provided specifically that it should not take notice of any trust over its shares.

(b) *Where persons claim rights in shares under equitable titles, such as an equitable mortgage, the company is not made into a trustee if those persons merely serve notice on the company of the existence of their equitable claims.* The correct way of protecting such an interest is by serving a stop notice on the company.

It follows from this branch of the 'no trusts' rule that where there are two or more lenders on the security of the same shares by way of equitable mortgage, the first in date has priority, not the first to give notice to the company.

Société Générale de Paris* v *Walker (1885) 11 App Cas 20

James Walker was the registered owner of 100 shares in Tramways Union Ltd, and he created two charges over the shares, one on 9 March 1881 in favour of James Scott Walker, who took the certificates and a blank transfer, and one on 1 December 1882 in favour of the appellants, the latter charge being created by means of a blank transfer, duly executed but without the deposit of the share certificate. The appellants tried to obtain registration first, but Tramways Union Ltd would not register the transfer without the certificates, and later the executors of James Scott Walker informed the Tramways Union that they had the certificates. This action was brought to decide who had the title to the shares. The articles of Tramways Union Ltd provided that the company should not be bound to recognise any equitable interest in its shares. The appellants claimed that because they notified first the fact of their equitable interest in the shares, they were entitled as against the executors of James Scott Walker.

Held – by the House of Lords – they were not, because neither the company nor its officers could be treated as trustees for the purpose of notifying equitable interests over the shares. The title to the shares was in the person eventually registered by the company, and the company was right in refusing to register a person who could not produce the share certificates. The respondents were entitled to the shares.

It should be noted that s 126 only protects the company, and where directors register a transfer, *knowing it is being made in breach of trust or in fraud of some person having an equitable right*, they may incur personal liability to the person suffering loss.

The rule also means that there can be no registration of a trust as such. An entry on the register such as 'The ABC Family Trust' would be an infringement of s 126. The correct entry and the share certificate should show merely the names of the individual trustees without any reference to the fact that they are trustees or the nature of the trusts. If a note of the existence of the trust is required for administrative purposes this can be recorded outside the register possibly with a coded cross-reference.

If a trustee of shares is entered on the register, he is personally liable for the calls made by the company, though he can claim an indemnity to the extent of the trust property and, if this is not sufficient, from the beneficiaries personally. A company cannot put a beneficiary on the list of contributories in a winding-up, though it can enforce the trustee's right of indemnity against the beneficiaries by the doctrine of *subrogation* (*per* James LJ in ***Re European Society Arbitration Acts*** (1878) 8 Ch D 679).

A company claiming a *lien* on its shares will be affected by a notice of any charge which arose prior to the debt in respect of which the company's lien is being exercised. As we have seen, this is not regarded as a notice of trust, but is more by way of a notice of lien as between one trader and another (see ***Bradford Banking Co*** v ***Briggs***, 1886).

Termination of membership

Termination of membership is complete when the name of a former member is removed from the register. This may occur by:

(a) transfer of the shares to a purchaser or by way of gift (subject to liability to be put on the list of members for one year if the company goes into liquidation) (see further Chapter 27);
See p. 593
(b) forfeiture, surrender, or a sale by the company under its lien;
(c) redemption or purchase of shares by the company;
(d) the registration of a trustee in bankruptcy, or by his disclaimer of the shares;
(e) death of the member;
(f) rescission of the contract to take the shares arising out of fraud or misrepresentation in the prospectus, or by reason of irregular allotment;
(g) dissolution of the company by winding-up or amalgamation or reconstruction under Insolvency Act 1986, s 110 (see Chapter 24);
See p. 530
(h) compulsory acquisition (see further Chapter 24);
(i) under the provisions of the company's constitution, e.g. expulsion under the articles for competing with the company (see ***Sidebottom*** v ***Kershaw Leese***, 1920).

Director and substantial shareholdings

As we have seen, the register of members merely gives the identity of the person in whose name the shares are registered. No indication is given of any interests in the shares which persons other than the registered holder might have. Furthermore, no notice of trust is to be entered on the register of members of a company registered in England. Where share warrants are in issue the position is, of course, worse since the names of the holders at any point of time are unknown, there being no form of registration.