MODERN COMPANY LAW
For a Competitive Economy

Company Formation and Capital Maintenance

A Consultation Document from the Company Law Review Steering Group

October 1999
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Executive Summary

1. This Consultation Document is one of three to be issued by the Steering Group set up to take forward a fundamental review of Company Law. It consults in detail on the Steering Group’s proposals in respect of company formation and capital maintenance.

2. We are in parallel publishing Consultation Documents on company general meetings and shareholder communication (URN 99/1144) and on reforming the law concerning overseas companies (URN 99/1146). These are being published separately because the likely readership of these Documents is expected to be largely different.

Company Formation

3. The Chapter of the Consultation Document on company formation deals with a number of issues concerning the formation of new companies under the future legislation which will emerge from the Review. Some of the changes proposed are quite radical, and it will be necessary in due course to consider the transitional arrangements which will be needed to accommodate existing companies to the new regime. But we can say at this stage that we do not envisage requiring existing companies to reregister under the new law.

4. The present proposals deal with the formation of entirely new companies. They do not cover the reregistration of one type of company as another – for example the conversion of a private company into a public company. Proposals on that will also come forward later.

5. Perhaps the most far reaching proposal is that concerning the constitution of a company. At present, this is contained in two separate documents – the Memorandum of Association and the Articles of Association. We propose that new companies should in future have their constitution in one document, broadly corresponding to the Articles. This would be presented for registration along with a new Registration Form containing information which must be on the public register and much of which is now included in the Memorandum. The information would not however include the company’s authorised share capital; it is proposed to abolish the concept of authorised share capital, as distinct from issued share capital.
6. The provisions of the constitution, like those of the Articles now, could be amended by special resolution. The more onerous requirements for changes to the Memorandum, including court approval, would go; but it would be possible for companies, on formation or later, to entrench provisions in the constitution, so that they could be changed only by unanimity.

7. Our provisional view is that it should remain possible to form a new company of any of the existing types – a company limited by shares, either public or private; a company limited by guarantee; or an unlimited company. But this is subject to further work in the Review on forms of incorporation available to business, particularly small business. We propose that the law should continue to offer model constitutions for companies of each type – the present Tables A, C and E – with default rules to ensure that companies are not formed with defective constitutions. The content of these models will be examined later in the Review.

8. It is proposed that in future it should be possible to form a company of any type with a single member only.

9. As the law stands, the founder members of a new company are the subscribers to the Memorandum. In future, it is proposed to define the founder members as the persons who sign the new Registration Form as members. Their names would as now be entered in the company’s register of members and from then on the company’s members would be those whose names were from time to time entered on the register.

10. It is proposed to clarify the relationship between the company and its members by providing that the company’s constitution is binding as between the company and its members and between the members themselves. We invite views on whether it would be helpful to characterise these relations explicitly as contractual.

11. We propose to retain the present system for the registration of new companies with some modifications. The founder members would submit to the registrar of companies the new Registration Form and a copy of the company’s constitution. These would be accompanied by a formal statement of compliance which would no longer have to be in the form of a statutory declaration. If the registrar was satisfied with these documents, and that the proposed name complied with regulations in force at the time, he would issue a certificate of incorporation.
which would, as now, be conclusive. (The provisions relating to company names will be considered separately.)

12. The Chapter also deals with a company’s objects, its capacity and the powers of the directors to bind the company. It is proposed to abolish, at least for private companies, the requirement that a company must have objects. It is also proposed that, in its relations with third parties, a company should have unlimited capacity, thus dealing once and for all with the problem of “ultra vires”. But it would remain possible for the members to bring proceedings to restrain the directors from acting contrary to the company’s constitution, including its objects if the company had any. It would also become possible for the shareholders to ratify such an act by the directors.

13. As now, if a person was dealing with a company in good faith, the power of the directors to bind the company would be free of any limitation under the constitution. But this safeguard would continue to apply only in favour of genuine third parties; “insiders”, connected with the directors, would not be protected in this way. It would also remain possible for the members to take proceedings to restrain directors from exceeding their powers. The application of the proposals in this and the previous paragraph to charitable companies will be considered separately.

14. It is also proposed to abolish “deemed notice”, so that a person will no longer be presumed to have notice of something merely because it is disclosed at Companies House or in the company’s own records available for inspection.

15. Most of the above proposals would apply to public as well as private companies. But there are a few differences because of the need to comply with EU law. Thus, the constitution of a public company will have to state the company’s objects, and must provide for initial share capital of at least the authorised minimum of £50,000; and the incorporation certificate must state that the company is a public company.

**Capital Maintenance**

16. This Chapter of the Consultation Document is concerned with the rules which restrict the freedom of companies to return to their shareholders funds which were originally subscribed for shares. It also covers the rules which ensure that full value is received for shares on issue
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including, for public companies, the requirement that a minimum amount of share capital should be subscribed in the first place. In the case of public companies, the Second EU Company Law Directive (the Second Directive) lays down detailed rules for capital maintenance. In some cases we believe that changes in these are desirable, but the proposals in this Document are consistent with present EU rules.

17. We understand that the original purpose of many of the capital maintenance rules was to protect creditors by preventing companies from dissipating funds subscribed for shares. We note however from responses to our earlier consultation that major creditors attach relatively little importance to the amount of a company’s share capital, compared with other indicators of its creditworthiness; and that for many private companies the amount of share capital subscribed is in any case minimal.

18. At present, there are two rules, for both public and private companies, designed to ensure that full value is received when shares are issued. The shares must be paid up in money or money’s worth; and they may not be issued at a discount to their nominal or par value. It is proposed to keep the former rule. But it is proposed to abolish for private companies the requirement for shares to have a par value. Instead, a share would represent simply a proportion of the value of the company. We believe that a similar reform for public companies would be welcome, but the concept of par value is enshrined in the Second Directive. The Directive also requires us to retain the current restrictions on the giving of commissions and discounts on the issue of shares of public companies, but we seek views on whether these restrictions should still apply for private companies. We are also obliged to retain for public companies detailed rules for the case where shares are issued other than for cash, though we see some scope for simplification.

19. The present powers to restructure share capital by consolidating or subdividing shares would remain, subject to appropriate disclosure requirements; and we note that a proposal of the Department of Trade and Industry (‘the Department’) to permit the redenomination of share capital into a different currency is outstanding. But we doubt if it is any longer necessary to legislate for long term uncalled capital.
20. We are obliged to retain a minimum capital requirement of at least 25,000 euros for public companies, and we seek views on whether the current higher minimum of £50,000 in UK law is appropriate.

21. For private companies, the abolition of par values means that the concept of share premium is also superseded; we suggest its replacement by a simple rule that when new shares are issued, the undistributable reserves are increased by the net proceeds of the shares. For public companies, the present rules on share premium would remain, though we suggest some tightening of the rules on its application. We seek views on the retention of merger relief from the rules, for both public and private companies; and we propose the retention of group reconstruction relief; for private companies, the disappearance of par values and share premium will require some reformulation of this relief.

22. We propose a major relaxation of the rules governing the reduction of share capital. Instead of the present provisions, which require companies, public and private, to seek court approval in every case, we propose that a company should be able to decide by special resolution to reduce its share capital, provided that the decision is supported by a solvency statement. For public companies only, the Directive requires us to provide creditors with a right to apply to the court to annul the reduction. This would be supported by disclosure requirements to ensure that creditors were aware of the proposal.

23. This Chapter also covers financial assistance by a company for the acquisition of its own shares. For private companies, we seek views on the alternatives of complete removal of all restrictions on financial assistance, and significant relaxations of the present “whitewash” provisions. For public companies we are constrained by the Second Directive, and therefore seek views on a number of limited improvements, most of which have already been the subject of consultation by the Department.

24. We propose to retain the present rules on redeemable shares, and purchase by a company of its own shares, but invite views on certain modifications. In particular, we suggest that if the above proposals for substantial relaxation of the provisions for reduction of capital by
a private company are accepted, it will not be necessary to retain the special procedure by which a private company may redeem its shares out of capital.

25. We propose that the rules governing dividends and other distributions by companies to their shareholders should be limited expressly to distributions to shareholders in their capacity as such; and that the statutory distribution rules should in future displace existing common law rules. We hope that this will resolve uncertainty about the scope of these rules. That apart, we suggest the retention of the main lines of the present rules but seek views on some modifications. The accounting provisions which support the distribution rules will be considered separately in the context of the work of the Review on the law relating to company financial reporting.
1.1 Our first Consultation Document\(^1\) outlined the Steering Group’s preliminary thinking on, amongst other subjects, three issues:

- company formation (chapter 5.3);
- capital maintenance (chapter 5.4); and
- the company law rules applying to oversea companies (chapter 5.6).

These were key issues where, at a relatively early stage in the Review, the Steering Group was clear about the likely shape of its recommendations.

1.2 This Consultation Document takes forward the first two of these issues to the degree of detail which would be required as a basis for instructions to Parliamentary Counsel for the drafting of a Bill. We are in parallel publishing a comparable Consultation Document on reforming the law concerning oversea companies (URN 99/1146). Separately, a Consultation Document is being published on company general meetings and shareholder communication (URN 99/1144).

1.3 It is important to outline the background to the present Document, and the stage which it represents in the overall Review.

1.4 We foresee, in relation to each substantial block of work in the Review, three successive stages of work. The first is to identify in very general terms the proposed position; in this, the second year of our three year review, we are working hard on a broad front, and we are aiming to publish a Consultation Document in the first quarter of next year which will indicate clearly the Steering Group’s provisional conclusions on many key issues. The second stage is that reached in our February Document on subjects such as company formation and capital maintenance, where we set out a clear position with a fair degree of detail, but well short of the degree of analysis which is required as a basis for drafting legislation. The third stage is that which is reached in relation to the company formation and capital maintenance in the present Consultation Document. This seeks to capture with the necessary precision and detail exactly

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Introduction and Background

what new legislation would need to say. Thus this Document analyses in detail the changes required from the current Companies Acts; and it is close in form to the detail which is required by Parliamentary draftsmen for the preparation of a Bill. As part of this process we have thought it worthwhile asking some of the questions posed in the February Consultation Document afresh, or in a slightly different context, so that consultees can address the Review’s conclusions on key areas against the background of the detailed changes to the law that they would entail. This will help ensure that these conclusions remain valid.

1.5 The present Document is therefore important in its own right in relation to these two key subject areas. But it is also important because it illustrates the degree of detail which will be required across the entire breadth of the Company Law Review. At a rough estimate, there are approximately fifteen, clearly identified areas of work which will require similar treatment; or, to express it differently, the subject matter in this Document on the two subjects of company formation and company maintenance represent in the current Companies Acts a total of some 120 sections out of a total of some 750 sections in the current Acts.

1.6 It is worth making a number of points about the present Document.

1.7 Part of the complexity of Company Law derives from the inter-relationships between different elements of the overall framework. We are very conscious of the fact that we are consulting on key issues which could be influenced by decisions which have not yet been reached in related areas. For example we have not yet reached firm conclusions on the approach to be taken on small and closely held companies, and these are very likely to influence the detail on subjects like capital maintenance or company formation. There is a clear sense in which this Review is an iterative process, in which it will not be possible to finalise the position until all parts of the jigsaw are in place. But equally the process of Review would be unmanageable if we were not to consult on key areas of work as and when our thinking is sufficiently developed. It is important then to emphasise that the conclusions in this Document are provisional in the sense that they may need to be revisited in the light of subsequent conclusions in different areas. This does not in our view call into question the validity of consultation at this stage; indeed we believe it is vital to invite views as we go along on the major issues that emerge.
1.8 Our earlier Consultation Document was written with a broad readership in mind; it is our strong belief that Company Law is of wide significance and importance for all concerned with our economic system. We were pleased that a number of respondents commented very positively on this. However we must concede that the present Document is inevitably rather technical in nature and that it is likely to appeal to a rather more specialist readership. We would point the more general reader to the summaries at the beginning of each of the sections; we very much hope that the more general reader will stay engaged with the discussion, even if we acknowledge that the Document can hardly be regarded as light reading!

1.9 Readers may like to note that our Consultation Document on company general meetings and shareholder communication, which is being published at the same time as this Document, contains a brief account of work in hand in the Review since February, when our last Consultation Document was published.

1.10 Like the earlier Document this Consultation Document is the work of the Steering Group of the Company Law Review. It does not represent the views of any particular individual or group that has participated in the Review. Nor does it represent Government policy. The plan remains that the Government will issue a White Paper in 2001 to outline its proposals on the basis of the outcome of the Review.

1.11 We would welcome comments on the issues raised in this Document. There is much detail contained in this Document and we are keen to allow sufficient time for consultation, in particular in representative organisations which require time to consult their membership fully. But the wider timetable means that we would welcome comments by 7 January 2000 if at all possible. Responses should be in writing and should be sent to:
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In accordance with the code of practice on open government, comments made on this Document may be made publicly available unless consultees specifically request otherwise. Additional copies of this Document may be obtained by telephoning 0870 1502 500; the Document is also available from the Review pages on the Department’s Internet site (http://www.dti.gov.uk/cld/review.htm).
Introduction

2.1 The Consultation Document “Modern Company Law for a Competitive Economy – The Strategic Framework” set out in Chapter 5.3 some preliminary conclusions on issues arising on the formation of a company and sought views on a number of questions. The present Document, which takes account of responses to those questions, makes detailed proposals for the statutory provisions on these matters which would replace those of the Companies Act 1985 (CA1985).

The provisions of CA1985 covered are:

- Part I: Chapter I: sections 1-24: Company Formation (with most of section 117 – public company share capital requirements); and

- Part I: Chapter 3: sections 35-35B: A company’s capacity and the powers of directors to bind the company (with section 322A – invalidity of certain transactions involving directors etc and section 711A – exclusion of deemed notice).

The provisions on company names – Part I Chapter II of CA 1985 – may be the subject of separate consultation.

2.2 This Chapter discusses the issues topic by topic and puts forward a number of proposals for consultation. These proposals represent the considered views of the Steering Group at this stage of the Review, but are subject to revision in the light both of the responses to the present consultation and to the outcome of continuing work on other aspects of the Review. Annex A analyses the relevant provisions of CA 1985 section by section and indicates whether, if the proposals in this Chapter are accepted, they would be retained, modified or deleted.

2.3 The Review is being conducted on the principle “Think small first”. Accordingly, the following proposals have been grouped in two parts: Part A, proposals for all companies; and Part B, additional proposals for public companies. This arrangement may however require reconsideration when current work on the small company is completed early next year.
Part A: Proposals for All Companies

The Members of the Company

2.4 As the law stands, the first members of a newly formed company are the subscribers to
the Memorandum who are deemed to have agreed to be members (CA1985 section 22(1)). It is
proposed to retain the substance of this provision in modified form, by providing the that the
persons who have signed a new Registration Form (see paragraph 2.16 below) are deemed to
have agreed to be the founder members of the company

Question 1 Do you agree with the proposal in paragraph 2.4 for defining who are the
founder members of the company?

2.5 At present, the “subscribers” must be entered as members of the company on the
company’s register of members, and a person who subsequently agrees to become a member, and
whose name is entered on the register of members, is also a member (CA1985 section 22(1) and
(2)). (The Treasury has proposed in a consultation paper of July 1999 that in relation to
uncertificated securities, it should be the records maintained by the Operator rather than the
company register maintained by the company or its registrar which confer legal title and
company membership. This change is intended to eliminate, for uncertificated securities, the gap
between the settlement of a transaction and the transfer of legal title to shares.) These provisions
will also be examined as part of the review of the requirements as to company registers.

The Legal Relationship between the Company and its Members

2.6 CA1985, section 14(1) is based on the principle that the Memorandum and Articles
amount to a deemed contract between the company and its members, and between the members
among themselves. But the effect of the case-law is that those documents fall short of being a
contract in any ordinary sense. They are more accurately characterised as the company’s
“constitution”, without however extending as far as to regulate all the legal relationships between
the component parts of the company.
2.7 Thus one feature of the “deemed contract” arising from section 14(1) is that members may only enforce rights given to them in their capacity as members. For instance, directors who are also members are not able to sue on provisions of the Articles governing their terms of appointment (as opposed to provisions governing eg the voting rights attached to their shares). Furthermore, members will not be able to assert rights arising under the Memorandum or Articles, if the act complained of is one which can be ratified by ordinary resolution and the right in question is classified as a “corporate” rather than a “personal” right.

2.8 It has been suggested that the scope of the “constitution” created by the Memorandum and Articles (or by the founding documents which will replace them) should be extended to include relationships with directors and other officers of the company. It is also for consideration whether the device of the “deemed contract” serves any useful purpose in interpreting the rights and duties which may be asserted under the company’s constitution. (The broader issue of what rights shareholders should be able to assert, and the extent to which they should be permitted to enforce duties owed to the company itself by means of a “derivative action”, is one which will be addressed in the context of shareholder rights and remedies.)

Question 2 Do you think that the relationship between the company and its members, and between the members themselves, is adequately defined by the present section 14(1)? Specifically, does it help to characterise these relationships as contractual? And should the relationships created by the constitution extend to the directors and officers of the company?

2.9 We do not think that it is necessary to keep the substance of section 14(2), that a debt owed by a member to the company is a speciality debt; this dates from an era when the analogy between the company’s constitution and a deed of settlement was still powerful.

Question 3 Do you agree that a debt owed by a member to the company should no longer be a specialty debt?
What Types of Company may be Formed?

2.10 Subject to further work on possible new corporate vehicles for small business, we propose that the three types of company provided for in section 1(2) of CA1985 should be retained both for existing and newly formed companies – the company limited by shares, the company limited by guarantee and the unlimited company. It is proposed to retain the substance of section 15 of CA1985, which prevents a company limited by guarantee with a share capital being established under the guise of a company limited by guarantee without a share capital. For companies with a share capital, it will be necessary to retain the distinction between a private company and a public company. A public company would be defined as a company registered or reregistered as a public company; and a private company would be defined as any company other than one registered or reregistered as a public company.

Question 4 Do you agree that the three existing types of company should be retained (without prejudice to the possibility of creating additional types)?

Question 5 Do you agree that a public and a private company should be defined as suggested in paragraph 2.10?

Who may Form a Company?

2.11 At present, a public company must be formed by two or more persons (CA1985 section 1(1)) but a private company may be formed by a single person (CA1985 section 1(3A)). We propose that one or more persons, natural or legal, should be capable of forming any type of company.

Question 6 Do you agree that it should be possible to form any type of company as a single member company?

2.12 As the law stands, the persons forming a company must be associated for a lawful purpose (CA1985 section 1(1)) (or in the case of a single member company, must form the company for a lawful purpose – section 1(3A)). It is probably impracticable even now for the registrar to reject a new registration for want of lawful purpose; this will be all the more true if
our proposals on a company’s objects are accepted (see paragraph 2.17 below). Nevertheless, we believe that it is worth retaining “lawful purpose” as one of the requirements of registration with which those forming companies must declare their compliance (see paragraph 2.31 below). The declaration of compliance is likely to have some preventive effect in this regard (and lack of a lawful purpose will continue to support winding up on the “just and equitable” ground).

**Question 7** Do you agree that the requirement that a company be formed for a lawful purpose should be retained?

**The Constitution of a Company**

2.13 Under the present law, the Memorandum of Association and the Articles of Association together comprise the constitution of a company. Broadly, the Memorandum includes the information which the outside world needs to know, while the Articles deal with the internal constitution of the company. Some information must be included in the Memorandum (*CA 1985 section 2(1) – (5)*), but the statute accepts that some information may appear in either (*CA 1985 section 17*). The extent to which the contents may be amended, and the procedure for amendment, also differs between the Memorandum and Articles. (*CA 1985 sections 4-6 and 9*).

2.14 It is proposed to replace the separate Memorandum and Articles and the various other documents required to be registered on formation with the “constitution” of the company in a single document, which would be delivered for registration along with a standard Registration Form. The Registration Form, when duly registered, would be the “instrument of incorporation” for the purpose of EU Directives.

**Question 8** Do you agree that, for newly formed companies, the Memorandum and Articles of Association should be replaced by a constitution in a single document, accompanied by a standard Registration Form?

2.15 It is not proposed to require existing companies, with a Memorandum and Articles of Association, to reregister constitutional documents in the new form. Detailed proposals for transitional arrangements for such companies will be made later, but the broad intention is as that the proposals for alterations to the constitution (see paragraph 2.27 below) would apply to
provisions in the Memorandum which could have been in the Articles. In view of the reduced significance of the company’s objects proposed in paragraphs 2.17 and 2.35 they would also apply to alterations in an objects clause. The proposals for entrenched provisions in the constitution would be applied to entrenched provisions in a Memorandum. It would be for consideration whether the right to apply to the court to cancel an alteration to a Memorandum need be preserved.

Question 9  Do you agree that existing companies should not be required to reregister, but that transitional arrangements on the above lines should be worked out?

Question 10  Should the right to apply to the court to cancel an alteration to the Memorandum be retained?

The Registration Form

2.16  It is proposed that this should be prescribed by the registrar for each type of company. It should contain two kinds of information. The first category would be basic information which third parties need to know and which cannot by law be changed without the intervention of the registrar. This would include:

- the name of the company;
- the type of company; and
- the jurisdiction of incorporation (cf. CA1985 section 2(1) and (2)).

2.17  It is proposed that there should no longer be a general requirement on companies to state their objects in their constitution (CA1985 section 2(1)(c)). But see paragraph 2.45 below on public companies. It is not proposed to retain statutory provision for companies to be formed with the objects of a general commercial company (CA1985 section 3A).

2.18  The second category would comprise information that is ephemeral in the sense that it may (while valid as a historic record of the position on formation) be superseded by later information submitted in the annual return and other notifications required to be made to the
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registrar (subject to further consideration in the Review of the requirements to report to the registrar). This would include:

- the intended address of the registered office on incorporation;
- the names of the founder members;
- for companies limited by guarantee, the amount of the guarantee by each member;
- for companies limited by shares, the amount of share capital initially subscribed, the number of shares into which it is divided and the number of shares held by each founder member; and
- the names of the first director(s) and secretary(ies)

(cf. CA1985 sections 2(4), (5)(a) and (c) and 10 (2) and (6).

Question 11 Do you agree with the proposals in paragraph 2.16-18 for the content of the new Registration Form?

Question 12 Do you agree that for private companies the requirement to have objects should be dropped?

Question 13 Do you agree that the option of registering the objects of a “general commercial company” should be withdrawn, with appropriate savings for companies already formed with such objects?

2.19 It is proposed that this form should be signed by the founder members and witnessed (CA1985 section 2(6)). It is proposed that the first director(s) and secretary(ies) should also sign to confirm their willingness to serve (CA1985 section 10(3)) and that particulars of each should be included in the form. It is also proposed that the director(s) should be required to confirm that they have informed themselves about their duties as directors. (The Law Commission and the Scottish Law Commission, in their report “Company Directors: Regulating Conflicts of Interest and formulating a Statement of Duties” (July 1998) suggested that a director should sign a statement that he has read a non-statutory statement of a director’s duties when confirming that
he has been appointed a director. We shall be considering this suggestion also in the context of directors’ duties, but we should also be interested in views at this stage.)

Question 14  Do you agree that the new Registration Form should be signed by the first director(s) and secretary, whose particulars would be included?

Question 15  Do you agree that the director(s) should confirm that they have read a statement of their duties as directors?

2.20 It is proposed that there should be a power, subject to negative resolution, to prescribe the new Registration Forms for each type of company (cf. CA1985 section 3(1) relating to the Memorandum). This power would be wide enough to cover such incidental matters as delivery by an agent (cf. CA1985 section 10(4)).

Question 16  Do you agree that a power as described in paragraph 2.20 should be provided?

The “Constitution”

2.21 This would closely resemble the present Articles. It would “prescribe the regulations for the company” (CA1985 section 7(1)) – ie it would set out the company’s internal arrangements on matters such as those dealt with in Table A. (In our consultation on capital maintenance we proposed to abolish the concept of authorised share capital, together with par values at least for the shares of private companies. The provisions replacing those here referred to would need to take account of this.) It is proposed that the constitution document must be signed by the founder shareholders and witnessed before delivery to the registrar. (CA1985 section 7(3)(c)).

Question 17  Do you agree with proposals in paragraph 2.21 on the content and signature of the company’s constitution?

Model Constitutions

2.22 Table A is to be prescribed as a model constitution, with a power for the Secretary of State to amend (CA1985 section 8(1)). (The possibility of preparing a new version of Table A, or
different versions for public and private companies and/or for small private companies, is under separate consideration). Companies should be free to choose whether to adopt this with or without amendment. As now, alterations to the version of Table A for the time being prescribed would not affect the constitution of a company registered before the alteration (CA1985 section 8(3)).

2.23 It is proposed to retain a statutory default provision on the lines of CA1985 section 8(2), so that companies would have the following options

a) register no constitution – Table A would apply;

b) register a constitution consisting of some provisions of Table A but with specified exclusions or amendments – Table A would apply with those exclusions and amendments; and

c) register a self contained constitution – that constitution would apply.

2.24 It is proposed that versions of Tables C and E would be prescribed for the forms of constitutions of companies limited by guarantee and for unlimited companies with a share capital, with a power for the Secretary of State to amend. The present tables C and E are subject to review by Working Group D.

2.25 It is not proposed to retain separate provision for a model constitution for a partnership company – Table G (CA1985 section 8A) has not been commenced, and statutory authority is not required to enable private sector organisations to promote model constitutions for any purpose).

2.26 It is proposed that there should be a power, subject to negative resolution, to prescribe the form of constitution for each type of company (cf. CA1985 section 8(5)); this would be wide enough to cover incidental matters such as the layout and means of delivery (cf. CA1985 section 7(3)).

**Question 18** Do you agree with these proposals to retain the substance of the present statutory provision for Table A and other model constitutions for companies of various types, but to drop the specific power to prescribe a model constitution for a partnership company?
Alterations to the Constitution

2.27 It is proposed that the constitution should be amendable by special resolution (CA1985 section 9(1)). But it is also proposed that the founder members should be able to provide in the constitution registered on formation of the company that specified provisions of the constitution should not be capable of amendment or should be amendable only by a higher majority than required for a special resolution. Such an entrenchment provision might also be inserted into a company’s constitution after formation; it is suggested that this should require unanimity, as should the removal of an entrenchment provision. This would reflect the present position where provisions can be entrenched on formation by being included in the Memorandum. It is also proposed to retain the provision that an alteration to the constitution which requires an existing member to take more shares, or to increase his liability to contribute to the company’s share capital, or to pay money to the company, is not binding on the member unless he specifically agrees to be bound. If a minority considered itself prejudiced by any other proposed amendment, recourse to the unfair prejudice remedy (CA1985, section 459) could be available (CA1985 section 16(1) and (2)).

Question 19 Do you agree that the general rule should be that the constitution of a company should be amendable by special resolution, but that it should be open to the members to entrench provisions so that unanimity would be needed to change or remove them?

Publicity for the Constitution

2.28 It is proposed to provide that a copy of the constitution must be sent to any member of the company, free of charge, on request. This copy should include all alterations made up to the date of the request. (The requirement to send a copy of any act of Parliament which has made a change would not be retained.) There would be sanctions for failure to comply with this requirement (CA1985 sections 19 and 20).
2.29 Where the constitution is altered by special resolution, it is proposed that the company should send to the registrar, in addition to the copy of the resolution, a copy of the constitution as amended. Where the constitution is altered by statute or statutory instrument, a copy of the constitution as amended should be sent to the registrar (in compliance with an obligation under the First Directive), together with a note identifying the statute or instrument making the alteration. There should be sanctions for failure to comply with these requirements (CA1985 section 18(1), (2) and (3)).

Question 20 Do you agree with proposals in paragraph 2.28 and 2.29 on the publicity to be given to a company’s constitution?

Method of Forming a Company

2.30 It is proposed that the founder member(s) should form a company by adopting a constitution and complying with the registration requirements (see paragraph 2.28 below) (CA1985 section 1(1)).

The Registration Process

2.31 The Registration Form is to be delivered to the registrar responsible for the jurisdiction of registration (England and Wales or Scotland). It must be accompanied by a copy of the constitution, and by a formal declaration of compliance by a director or secretary (CA1985 section 10(1) and 12(3)). This would no longer be a statutory declaration, but would be subject to penalties for false or reckless making.

2.32 On receipt of the Registration Form, duly accompanied by the copy of the constitution and the compliance declaration, the registrar’s duty would be to register the form and the constitution. The registrar would be entitled for this purpose to accept the declaration of compliance at its face value; but the registrar’s obligation to register will be subject to his duty to ensure that the proposed name is compliant with regulations in force at the time. On registration, the registrar would issue an incorporation certificate, duly signed or authenticated (CA1985 sections 12(1), 12(2), 13(1), 13(2)).
Question 21  Do you agree with the proposals in paragraph 2.31 and 2.32 on the formation and registration of a company?

The Effect of Registration

2.33 From the date of the issue of the incorporation certificate the company would exist as a body corporate with a separate legal personality with such liability on the part of the members as was provided in the constitution, and with the name under which it was registered. The first director(s) and secretary(ies) named on the Registration Form would be deemed to be appointed as director(s) and secretary(ies) (CA1985 section 13 (3), (4) and (5)). The appointment of a director or secretary named as such in the constitution delivered to the registrar would be void unless the person concerned was named as a director or secretary, and had indicated their consent, on the Registration Form (CA1985 section 10(5)).

2.34 The incorporation certificate would, as now, be conclusive evidence that the company named in it had been registered and existed as a separate legal person (CA1985 section 13(7)(a)).

Question 22  Do you agree with the proposals in paragraphs 2.33 and 2.34 on the effect of registration, including specifically the proposal to retain the conclusive effect of the incorporation certificate?

A Company’s Capacity

2.35 It is proposed that in future a company should have unlimited capacity, and a provision to this effect would replace CA1985 section 35(1). This would be effective regardless of anything in the company’s registration form or constitution, including provisions specifying the company’s objects. But where a company does retain provisions in its Registration Form or constitution which would, but for the above, limit its capacity, it is proposed to retain the right of a member of the company to take proceedings to restrain the doing of anything contrary to those provisions, without prejudice to the rights of third parties. (CA 1985 section 35(2)). It is also proposed that where the directors act contrary to such provisions it should be possible for the members to ratify those actions. It is proposed that an ordinary resolution should suffice for this purpose (cf. CA 1985 section 35(3)).
2.36 It is proposed that the above provisions should continue to be subject to the relevant provisions of Charities legislation and to rules currently in CA1985 section 322A (see para 2.41 below) on transactions to which directors and their associates are parties (CA1985 section 35(4)).

Question 23 Do you agree that a company should henceforth have unlimited capacity, regardless of anything in its constitution, including its objects, but that a member should continue to be able to take proceedings to restrain the doing of an act contrary to the constitution?

Question 24 Do you agree that in the case of charitable companies this should continue to be subject to the special provisions of charities law?

Power of the Directors to Bind the Company

2.37 It is proposed to retain the provision that, in favour of a person dealing with the company in good faith, the power of the board of directors to bind the company shall be free of any limitation under the company’s constitution (CA1985 section 35A(1), as interpreted by section 35A(2) and (3)).

2.38 It is proposed to retain the right of a member to bring proceedings to restrain the directors from acting beyond their powers, except that, as now, this would not apply to the restraint of an act in fulfilment of an earlier obligation. (CA1985 section 35A(4)). The liability which might be incurred by the directors or anyone else by reason of the directors exceeding their powers would also be unaffected (CA1985 section 35A(5)).

2.39 It is proposed that the above provisions should continue to be subject to the relevant provisions of Charities legislation and to rules currently in CA1985 section 322A (see para 2.41 below) on transactions to which directors and their associates are parties. (CA1985 section 35A(6)).

2.40 It is proposed to retain a provision that a party to a transaction is not bound to inquire whether it is permitted by a company’s constitution or beyond the powers of the directors. (CA1985 section 35B).
**Question 25**  Do you agree with the proposals in paragraph 2.37-40 relating to the powers of directors to bind the company, including specifically the proposal that special provisions should continue to apply to charitable companies?

2.41 The purpose of section 35A is to protect those dealing with the company, where they have entered into a transaction in good faith which was outside the authority of the directors. By section 35A(2)(b), for those purposes “bad faith” is not equated with a knowledge of the limitation on the directors’ authority. The section therefore amounts to an important exception to the usual principles of the law of agency, according to which a principal cannot be bound in respect of a transaction for which the agent has neither actual nor ostensible authority. However, the scope of that exception is limited by **CA1985, section 322A**, as regards transactions between the company and its directors (or persons connected with them). The rationale for that limitation is clear: in dealing with such persons, the company is not dealing with genuine “third parties”, but rather with “insiders” who should not be protected from the rigours of the usual principles of agency law. The effect of section 322A is, however, in some respects different from those usual principles. The Law Commissions, in their report referred to in paragraph 2.19 above, said that they were not aware of any deficiencies in section 322A. But it has been suggested that the elaborate detail of that section is unnecessary, and is confusing to the extent that it adds an additional layer of regulation to the principles which would otherwise apply. It is therefore for consideration whether section 322A could be replaced by a simpler provision which merely excluded directors and connected persons from the protection given by section 35A.

**Question 26**  Do you agree that the law relating to the powers of the directors to bind the company should be modified on the lines of the present section 322A where the other party is a director or a person connected to a director? Or should such persons simply be excluded from the protection given to third parties by the present section 35A?

**Abolition of Deemed Notice**

2.42 It is proposed to provide that a person is not to be assumed to have notice of a matter merely because it is disclosed on the companies register or made available for inspection by the
company (CA1985 section 711A, not commenced). But it is not proposed to include the qualification that a person may nonetheless be affected by notice of something if he fails to make reasonable inquiries (CA1985 section 711A(2)). The possible inclusion of an exception relating to company charges will be considered later in the context of the review of the law on company charges (CA1985 section 711A(4)).

Question 27 Do you agree that deemed notice should be abolished, with the possible exception relating to the Register of Company Charges; and that the qualification that a person may be affected if he fails to make reasonable inquiries should be dropped?

Part B: Additional Proposals for Public Companies

2.43 The following paragraphs relate to the registration of a company as a public company from the outset; the reregistration of a private company as a public company will be the subject of later consultation. It is proposed that the present two stage procedure for the incorporation of a newly formed public company, with separate incorporation and trading certificates, should be replaced by a single stage procedure like that for private companies. It is hoped in due course to secure agreement on the removal of the requirements of the Second EU Company Law Directive (the Second Directive) that a public company must have objects, and that its shares must have a par value or accountable par. But the present consultation is on the basis of the Directive as it now stands.

The “Constitution”

2.44 In addition to the provisions on the constitution applicable to all companies, the following requirements will apply in the case of public companies. In accordance with the Second Directive as it now stands it will be necessary to require the constitution of a public company to state the objects of the company (cf. CA1985 section 2(1)(c)). The amount of issued share capital stated in the constitution delivered to the registrar must, in the case of a public company, be not less than the authorised minimum (CA1985, section 11). The present authorised minimum is £50,000 (CA1985 section 118). The detailed provisions for the authorised minimum
and payment up will be dealt with in the context of capital maintenance. As the Second Directive stands, it will also be necessary to provide that the constitution must also state the division of the initial issued share capital into shares of a fixed amount (par value) (_CA1985 section 2(5)(a)_).

**Question 28** Do you agree with the additional requirements set out in paragraph 2.44 for the constitution of a public company?

**The Registration Form**

2.45 At present, when a newly formed company registers as a public company, it must submit a statutory declaration covering the following points (_CA1985 section 117(3)_):

- confirmation that the allotted share capital is not less than the authorised minimum;
- the amount paid up on the initial share capital;
- the amount of the company’s preliminary expenses and the person to whom they have been paid or are payable; and
- the amount of benefit to any promoter of the company, and the consideration for the benefit (_CA1985 section 117(3)(a) – (d)_).

2.46 It is proposed that in future this information should be included as additional detail on an expanded Registration Form for public companies, covered by a compliance declaration in the same form as for private companies. (It should be noted that the substitution of a single stage for a two stage incorporation procedure makes separate provisions on the lines of section _CA1985 section 117 (1), (2), (5), (6), (7) and (8)_ unnecessary.)

**Question 29** Do you agree with the proposals in paragraph 2.45 for the additional information on the Registration Form of a public company?

**Question 30** Do you agree that the registration of a newly formed company as a public company should henceforth be a single stage process?
The Registration Process and the Effect of Registration

2.47 In the case of a public company, it is proposed that the incorporation certificate should state that the company is a public company and that it should be conclusive evidence of that fact (as well as of other facts) (CA1985 section 13(6) and (7)(b)).

Question 31 Do you agree that the incorporation certificate of a public company should have conclusive effect?
Introduction

3.1 The Consultation Document “Modern Company Law for a Competitive Economy – The Strategic Framework” set out in Chapter 5.4 some preliminary conclusions on the law relating to the maintenance of a company’s capital – the doctrine that the resources contributed by the shareholders, while they may be lost in unsuccessful trading, may not simply be returned to the shareholders without safeguards for the creditors. Chapter 5.4 sought views on a number of specific questions. The present Document takes account of responses to those questions and makes detailed proposals for the statutory provisions on these matters which would replace those of the Companies Act 1985 (CA1985).

3.2 The provisions of CA1985 covered are:

Part IV: Allotment of Shares and Debentures (in part)

sections 97 and 98: commissions and discounts payable in consideration of a person’s agreeing to subscribe for shares;

sections 99-107: the amount to be paid on the allotment of shares and the means of payment;

sections 108-111: valuation provisions which apply when the shares of a public company are allotted for non-cash consideration;

sections 111A -116 miscellaneous matters arising out of the allotment of shares;

Part V: Share Capital, its Increase, Maintenance and Reduction:

Chapter 1: sections 117(4) and 118-124 general provisions about share capital;

Chapter III: sections 130-134: share premiums;

Chapter IV: sections 135-141: reduction of share capital;

Chapter V: sections 142-150: maintenance of capital;
Chapter VI: sections 151-158: financial assistance by a company for the acquisition of its own shares;

Chapter VII: sections 159-181: redeemable shares: purchase by a company of its own shares; and


3.3 This Chapter discusses the issues topic by topic and puts forward a number of proposals for consultation. These proposals represent the considered views of the Steering Group at this stage of the Review, but are subject to revision in the light both of the responses to the present consultation and to the outcome of continuing work on other aspects of the Review. Annex B analyses the relevant provisions of CA 1985 section by section and indicates whether, if the proposals in this Chapter are accepted, they would be retained, modified or deleted.

3.4 In developing proposals for the law in this area, we have kept two general considerations in mind. The first is the need, where public companies are concerned, to maintain compliance with the Second EU Company Law Directive on the maintenance and alteration of the capital of public companies (the Second Directive). Many of the provisions listed above date from the Companies Acts of 1980 and 1981 and were introduced to implement the Second Directive. Consultation has in some areas revealed a wish to change the law in ways not presently permitted by the Directive. The introduction of no par value (NPV) shares for public companies is a case in point. We do not exclude the possibility of seeking changes to the Directive; but unless the contrary is stated, this Document takes as given the need to comply with the Directive as it now stands. However, we have subjected to special scrutiny cases where the legislation extended to private companies requirements which the Directive laid down for public companies only.

3.5 The second general consideration is the response received to Question 26 in the Strategic Consultation Document which we issued in February of this year – “What is the significance of a company’s share capital (as opposed to its net assets or other features of its financial performance) for decisions on whether to extend credit to it?”. The view of a substantial majority of consultees (though by no means all) was that a company’s share capital is nowadays
relatively unimportant as a measure of its ability to repay credit, and that other measures, including net assets, cash flow and interest cover are considerably more important. This can be particularly so for private companies, which are subject to no minimum capital requirement.

**The Allotment of Shares**

3.6 Part IV of CA1985 applies to the allotment both of shares and debentures. This Document is concerned only with shares. Sections 80 to 96 relate to the authority which directors require to issue shares, to the procedure for allotment, to the return to be made to Companies House as to allotment, and to the pre-emption rights enjoyed by existing shareholders when new shares are issued. The broad purpose of these provisions is to protect existing shareholders against the risk that the directors will act in such a way as to dilute the value of their holdings. They are not concerned with the overall level of the company’s share capital. But sections 97-116 are concerned with ensuring that the full value is received for shares on allotment, and that share capital, at the time it is subscribed, is backed by assets. We consider that these provisions can logically be considered along with those of Part V.

3.7 The provisions limiting the giving of commissions and discounts out of capital on the issue of shares (CA 1985, sections 97 and 98) must be retained in substance for public companies in order to maintain compliance with Article 8 of the Second Directive, but it is for consideration whether the preservation of a company’s power “to pay such brokerage as has previously been lawful” (CA 1985, section 98(3)) serves a useful purpose; and, more importantly, the rule on commissions and discounts ceases to have meaning for private companies if they have no par value shares (see paragraph 3.8 below).

**Question 32** Do you agree that provisions limiting the giving of commissions and discounts out of capital on the issue of shares should no longer apply to private companies (regardless of your views on no par value shares – see below)?
Question 33 Do you agree that for public companies it is no longer necessary to preserve the power to pay “such brokerage as has previously been lawful”?

3.8 On the amount to be paid for shares, two rules apply both to private and public companies. Any consideration accepted in payment up of shares must be paid up in money or money’s worth (CA1985, section 99(1)); and shares may not be allotted at a discount to nominal (par) value (CA1985, section 100(1)). In the case of public companies, both provisions are required by the Second Directive. It is proposed to retain the former provision for both private and public companies. It is proposed that par value shares should be abolished for private companies; and that existing shares of private companies should be deemed to have no par value. The rule against allotment at a discount to nominal value will therefore disappear in its present form for private companies. It is suggested that it should be replaced by a rule that the consideration received or due for an issue of shares, net of any commission or discount given, must equal the amount credited to the (single) subscribed capital account which would replace share capital plus share premium. The rule against allotment at a discount to nominal value must be retained for public companies, for the present at least; (if in due course the requirement for shares to have a par value were removed from the Second Directive, the above proposal for private companies could be extended to public companies).

Question 34 Do you agree that for private companies it should no longer be possible to issue par value shares, and that existing par value shares should be deemed to have no par value?

Question 35 Do you agree that for private companies, the rule against allotting shares at a discount should be replaced by a rule that the consideration for newly issued shares, net of any commission or discount, should equal the amount credited to subscribed share capital?

3.9 For public companies only, additional detailed rules apply to the acceptance of and undertaking to do work or perform services (CA1985, section 99(2) and (3)); the payment up of shares as to one quarter of nominal values plus the whole of any premium (CA1985, section 101); the acceptance of payment up by means of a long term undertaking (CA1985, section 102);
the valuation of non-cash consideration (CA1985, section 103); the imposition of a valuation requirement where a company acquires an asset from a founder shareholder (CA1985, section 104); the consequences of contravening this last requirement (CA1985, section 105); a requirement that the founder shareholders of a company must pay up their shares in cash (CA1985, section 106). These are further supported by a definition of the rate of interest applicable to overdue payments under the previous section (CA1985, section 107); and by detailed provisions relating to the valuations required by sections 103 and 104 (CA1985, sections 108-111).

3.10 These sections were all introduced to implement provisions of the Second Directive, and the key elements will need to be retained for that purpose. But a number of simplifications and modifications are proposed, as follows:

section 101(5): It is suggested that the position of the allottee of bonus shares who is unaware that they have not been paid up should be clarified, by providing that in that case the allotment is void;

section 102(3)-(7): It is for consideration whether the elaboration provided by these subsections is needed;

section 103(2), (3), (4), (5) and (7): It is for consideration whether the elaboration provided by these subsections is needed;

section 106: In order to bring this provision into line with our proposals for changes in the law on company formation, it would need to be reformulated in terms of the founder shareholders and the shares of each recorded on the Registration Form. The definition in section 738(2) of “payment up in cash”, as it operates in relation to all these provisions, may have to be reviewed in the light of the requirements of the Directive;

section 107: It is suggested that this provision be dropped and the appropriate rate of interest left to the discretion of the court;

section 108: It is proposed to drop the detail in subsections (5), (6) and (7) in the interests of simplification;
section 109: It is proposed to drop the detail in subsection (3) in the interests of simplification;

section 110: It is for consideration whether the valuer needs a statutory right to require information (subsection (1)); and

section 111: It is proposed to drop the penalty on the company.

Question 36 Do you agree with the modifications and simplifications proposed in paragraph 3.10?

3.11 CA1985, sections 111A-116 contain miscellaneous provisions in support of Part IV, and apply to both private and public companies. It is proposed to retain these provisions in substance, with the following modifications:

section 113: It is proposed to replace the detailed provisions in subsections (2)-(8), giving guidance to the court when hearing a case relating to liability for contravention of section 99, with a general discretion for the court to grant relief from liability, and adjust liability between contributors, where it seems just and equitable to do so;

section 114: It is proposed to drop the penalty on the company; and

section 116: The provision for cases transitional at the time of the 1980 Act appears no longer to be needed.

Question 37 Do you agree with the modifications and simplifications proposed in paragraph 3.11?

General Provisions about Share Capital

3.12 CA1985, section 119 makes clear that a company may provide flexibility in its constitution about the amounts and timing of payment up of capital – in particular, so that the arrangements need not be the same for all shareholders. We believe that, as a matter of common law, the presumption of equality of treatment between shareholders can be displaced by the constitution; we therefore propose to drop this provision as superfluous.
Question 38  Do you agree that section 119 can be omitted as superfluous?

3.13 It is proposed to retain, in a modified and simplified form, the power of a company under CA1985, section 121 to alter its share capital by increasing it or by consolidating or subdividing its shares. The reference to the conditions in the Memorandum will disappear as a consequence of the changes proposed in the Chapter on company formation; and the proposal to abolish authorised share capital prompts the dropping of the power to increase the (authorised) share capital (CA1985, section 121(2)(a)). (A power to issue new shares is implicit in the authority which may be conferred on the directors under section 80 to allot shares). The power to consolidate or subdivide the company’s shares (CA1985, section 121(2)(b) and (d)) would remain without the reference to the Memorandum. So would the requirement that in a subdivision of partly paid shares the proportion between the amounts paid and unpaid must remain constant (CA1985, section 121(3)). The provision for the cancellation of unissued shares (CA1985, section 121(2)(e)) will fall with the end of authorised capital; and it is suggested that the power to convert shares into stock and vice versa (CA1985 section 121(2)(c)) is obsolete. It is suggested that the powers under this section should be exercised by ordinary resolution, but without the present express provision that this should be done in general meeting (CA1985, section 121(4)); (this does not exclude the use of the written resolution procedure by a private company (see CA1985, section 381A(1)), but may appear to do so). If the outstanding proposal by the Department to amend the law to facilitate the redenomination of share capital from one currency to another is implemented, the legislation resulting from the Review would reflect this.

Question 39  Do you agree that the power of a company to modify its share capital (other than by reducing it) should be retained with the modifications described in paragraph 3.13?
3.14 Our provisional view is that the requirement to notify changes in share capital to Companies House (CA1985, section 122) should be retained, with the deletion of the reference to the conversion of shares into stock and vice versa (see above on section 121); but the continuing necessity for such registration requirements is being considered separately in the general context of the requirements for disclosure at Companies House. The penalties on an officer of the company for contravention would remain but it is suggested that those on the company itself should go (CA1985, section 122(2)).

Question 40 Do you agree that the registration requirements for a modification of capital should be retained, with the modifications suggested in paragraph 3.14?

Question 41 Do you agree that the penalty on the company for breaches of the registration requirements for a modification of capital should be dropped?

3.15 CA1985, section 123 provides for notification to Companies House of an increase in authorised share capital and would disappear. It is for consideration whether the information now required to be notified on classes of shares and conditions of issue (CA1985 section 123(2)) should instead be required to be notified in the return of allotments under section 88 or whether section 128(1) deals satisfactorily with the need for such information to be notified.

Question 42 Given the intention to abolish authorised share capital, do you think that the need for disclosure of share allotments is adequately met by section 80, supplemented, in the case of shares with special rights, by section 128(1)?

3.16 We believe that long term uncalled capital – partly paid shares where the balance is payable up only in the event of a winding up – is obsolete. It is therefore not proposed to retain the provision made for such capital by CA1985, section 120, nor that made by CA1985, section 124 for the issue of additional capital in this form by unlimited companies. Transitional provisions will be considered later; but we should be grateful to know of the extent of the need to save these provisions for existing companies.
Question 43  Do you agree that it is no longer necessary to make provision for long term uncalled capital, whether of limited or unlimited companies?

Question 44  Do you think that it is necessary to preserve the present provisions for long term uncalled capital for existing companies?

3.17  For public companies only, the Second Directive obliges us to retain the requirement for a minimum allotted share capital of at least 25,000 euros (about £16,500). It is for consideration whether the present figure of £50,000 (CA1985, section 118(1)) should be maintained, increased or reduced. The present law provides for the figure to be changed by statutory instrument (CA1985, section 118(1)) and sets out in some detail what such an instrument may contain (CA1985, section 118(2)); the gist of this subsection should be retained, though it is proposed to examine the scope for simplifying the provisions now in paragraphs (b) and (c) of the subsection. The appropriate Parliamentary procedure (CA1985, section 118(3)) will be considered later along with other similar provisions in the legislation. It will also be necessary to include here the provision that employee shares which are not paid up should not count towards the authorised minimum (CA1985, section 117(4)). (The remaining provisions of section 117 relate to the registration of a newly formed company as a public company; they are covered in the Chapter on company formation.)

Question 45  Do you think that the present minimum allotted capital for public companies of £50,000 should be increased, reduced or stay the same?

Question 46  Do you think that the provisions in section 118(2)(b) and (c) on the content of an order increasing the authorised minimum could be simplified and made more general?
Share Premiums

3.18 Chapter III of Part V of CA1985 provides that where a company issues shares at a premium to their nominal value, the amount of the premium is to be transferred to a share premium account. The Chapter sets out the purposes to which the share premium account may be applied, and provides certain reliefs from the obligation to transfer amounts to the share premium account.

3.19 The proposal to abolish par value for the shares of private companies, and also for those of public companies if the Second Directive is amended on the point, would replace nominal capital and share premium as separate balance sheet items with a single undistributable reserve of subscribed share capital. As a result, any permitted applications of the share premium account, and any reliefs from the obligation to transfer amounts to the share premium account, must either be extended to the whole of the subscribed share capital or removed completely. The new legislation must therefore make provision for an NPV environment by setting out rules for the application of, and relief from transfer to, subscribed share capital; it must also retain parallel provisions for the share premium account on the assumption that these will, for the time being at least, be needed for public companies.

3.20 It is assumed that for private companies the balance sheet will be modified to replace called up share capital and share premium with a single reserve of subscribed capital representing the total proceeds of shares issued. For public companies, with par value shares, the provision that where shares are issued at a premium, the premium must be transferred to a share premium account (CA1985, section 130(1)) must be retained.

3.21 As a general principle, it is suggested that on an issue of shares the undistributable reserves should be increased by the net proceeds. A private company would therefore be permitted to deduct from the amount transferred to subscribed capital the expenses of an issue of shares of the same class; but this permission would not extend to the company’s initial expenses, to commission or discount paid or allowed on the issue of other shares or debentures, or to the premium payable on the redemption of debentures. For public companies, the permitted applications of the share premium account (CA1985, section 130(2)) would be similarly modified.
Question 47  Do you agree that on an issue of shares the company’s undistributable reserves should be increased by the net proceeds?

Question 48  Assuming that par value shares are abolished for private companies, do you agree that neither the company’s initial expenses, nor commission or discount paid on the issue of other shares, nor the premium payable on the redemption of debentures, should be deductible from the amount transferred to subscribed capital?

Question 49  For public companies, do you agree that the three items referred to in Question 48 should be excluded from the permitted applications of share premium account?

3.22 Relief from the obligation to transfer amounts to the share premium account is currently provided a) where shares are issued at a premium as consideration for the transfer or cancellation of another company’s shares in the context of a merger (CA1985, section 131); and b) where shares are issued at a premium as consideration for the transfer of assets in the context of a group reconstruction (CA1985, section 132). In the case of mergers, the relief extends to the whole of the premium; for group reconstructions, it is limited to any excess over the base value of the assets transferred.

3.23 For private companies, arguably, in accordance with the argument in paragraph 3.19 above, the choice is between extending the relief in each case to the whole of the proceeds of the shares or withdrawing it completely. In the case of mergers, the extended relief would risk serious erosion of the subscribed capital of the new company compared with the merging companies; in view of the less onerous procedure recommended for the reduction of capital, particularly by private companies (see paragraphs 3.27-3.35), one option would be to withdraw merger relief. Alternatively, the provision might be modified for private companies so that the amount to be transferred to subscribed capital is the amount of the book value of the other company’s capital and reserves attributable to the shares acquired or cancelled. For public companies, where the relief extends only to the premium, the case for removal of the relief is less strong. For them the amount to be transferred could, as at present, be the nominal value of the shares issued.
Question 50  For private companies, assuming the abolition of par value shares, do you favour a) the abolition of merger relief, or b) the alternative suggestion outlined above, or c) some other alternative.

Question 51  For public companies, do you favour a) the abolition of merger relief, or b) its retention in its present form, or c) some other alternative?

3.24  In the case of group reconstructions the danger of erosion of capital is substantially less, and we propose that relief should be retained. For private companies relief from transfer to subscribed capital would cover the excess of the consideration for the shares over the base value (as currently defined) of the assets transferred. For public companies, the substance of CA1985, section 132 would remain.

Question 52  For private companies, assuming the abolition of par value shares, do you support the retention of relief in respect of group reconstructions in the modified form suggested in paragraph 3.24?

Question 53  Do you favour the retention of such relief in its present form for public companies?

3.25  It is proposed to retain provision on the lines of CA1985, section 133 which sets out the consequences for the asset side of the balance sheet where merger relief or group reconstruction relief is available. For private companies, an appropriately modified provision would be needed under which, where all or part of the consideration for the shares is not transferred to subscribed capital, that amount may also be disregarded in determining the amount at which any shares or consideration for shares are included in the balance sheet. For public companies, the substance of section 133 would remain.

Question 54  Do you agree that the substance of section 133 should be retained?

3.26  It is proposed to consider the power in section 134 to amend or extend the reliefs later in the Review, in the context of other similar order making powers.
Reduction of Share Capital

3.27 At present, the law requires a company to seek court approval for any reduction in its share capital. It is proposed to replace this for private companies by a requirement that a capital reduction should be decided by a special resolution of the company, and that to protect creditors the directors should be required to make a formal declaration of solvency. For public companies, the same procedure would apply, except that in order to comply with the Second Directive, creditors would be given the opportunity, at their initiative, to challenge the reduction in court.

Question 55 Do you agree that the requirement on companies to seek court approval for a reduction of capital should end?

Question 56 Do you agree that it should be replaced by a decision of the company by special resolution, backed by a solvency statement by the directors, with, in the case of public companies only, a right of creditors to object to the court?

3.28 The requirement for authority in the company’s Articles, and for a special resolution, would remain, but the need for court confirmation in all cases would go (CA1985, section 135(1)). It is suggested that the non-exhaustive examples of how a reduction of capital might be achieved (reduction of liability on partly paid shares; cancellation of shares lost or not matched by assets, paying off shares in excess of the company’s wants) should remain, subject to amendment to remove the reference to the Memorandum (CA1985, section 135(2)).

Question 57 Do you agree that the list in section 135(2) of types of capital reduction should be retained, with the modification suggested in paragraph 3.28?

3.29 The existing provisions for the compulsory court procedure and for publicity (CA1985, sections 136-138) would be entirely replaced, as follows.

3.30 For both private and public companies, the directors would be required to make a formal declaration (which need not be a statutory declaration) of solvency, to the effect that the company will be able to pay its debts in the following twelve months or in the event of a winding up. It is suggested that (in a case where a company has auditors, but not otherwise) this
declaration should be accompanied by a report from the auditors to the effect that they have enquired into the state of the company and are not aware of anything to indicate that the opinion expressed by the directors in the solvency declaration is unreasonable in all the circumstances.

Question 58   (a) Do you think that the directors’ solvency declaration on a reduction of share capital should be supported by an auditors’ report?

(b) If so, do you agree that the auditors should report in the terms suggested?

(c) Do you agree that companies with no auditors should be exempt from a requirement for an auditors’ report?

3.31 For public companies only, there would be a statutory right for a creditor to object to any form of capital reduction except one to write off losses or, as is permitted by the Second Directive, one which would create an undistributable reserve of not more than 10% of the reduced capital. The grounds for objection would be that the proposed reduction did not offer the creditor security for the debt, or other safeguards; and that the company’s assets are not sufficient to make this unnecessary. There would be a delay of four weeks from the special resolution before implementation, to allow time for objections. The court would have wide powers to ban the reduction, or to impose conditions on it. The court would also have discretion to require a creditor who had taken action to pay all or part of the company’s costs. Where a creditor did not have reasonable grounds for objection, he should be required to pay all the costs.

Question 59 Do you think that capital reductions which would create an undistributable reserve of not more than 10% of the reduced capital should be exempt from the procedures proposed in paragraph 3.31?

Question 60 Do you agree with the proposals in paragraph 3.31 relating to the grounds on which a creditor might object, and to the time limit for objections?

Question 61 Do you agree that creditors found to have no reasonable grounds for objecting to a capital reduction should be liable at the court’s discretion for some or all of the company’s costs?
3.32 There would be disclosure requirements for both private and public companies. The notice of the meeting at which there was to be a resolution to reduce capital would have to specify the fact; in addition to a copy of the resolution, the company would have to deliver to the registrar copies of the solvency declaration and of the auditors’ report. In addition, it is suggested that a public company should be obliged to publish the resolution in at least three national newspapers, so that creditors have a reasonable opportunity to exercise the right to object. If the company fails to advertise in this way, the directors responsible should be liable to a fine; and a creditor who seeks to challenge the reduction after the expiry of the four week period, should have the same right to apply to the court for safeguards that he would have had earlier.

Question 62 Do you agree with the proposals in paragraph 3.32 for publicity for a proposed capital reduction, including the liability of directors and the rights of creditors if a company defaults on its obligations?

3.33 It is proposed to replace the provision dealing with the consequences of a court order reducing the capital of a public company below the authorised minimum (CA1985, section 139) with a simple prohibition on a public company reducing capital below the authorised minimum. The effect would be to oblige a public company wishing to do this to reregister as a private company before, or simultaneously with, the capital reduction.

Question 63 Do you agree that the present section 139 should be replaced by a simple prohibition against a public company reducing its capital below the authorised minimum?

3.34 The provision that where a capital reduction takes the form of a reduction in the liability on partly paid shares, a shareholder will not be obliged to pay up the difference between the original and the new amount payable should be retained (CA1985, section 140(1)).

3.35 Where a company reduces its capital contrary to the provisions set out above, including where the directors’ solvency declaration was made without reasonable grounds to believe in its truth, it is proposed that any director or shareholder knowingly party to the default should be liable at the suit of a creditor to pay up the capital reduced.
Question 64  Do you support the proposals in paragraphs 3.34 and 3.35?

Maintenance of Capital

3.36  The requirement (*CA1985*, section 142) that the directors of a public company which loses half or more of its paid up share capital must call an Extraordinary General Meeting (EGM) within 28 days to consider what steps to take must be retained to comply with Article 17 of the Second Directive.

3.37  The general rule against a company acquiring its own shares (*CA1985*, section 143) should be retained (for public companies it is needed to comply with Articles 18-22 of the Second Directive). The existing exceptions from the ban should also be retained (redemption or purchase in accordance with Chapter VII of Part V, acquisition in a reduction of capital, purchase in accordance with a court order, forfeiture for failure to pay up). The penalty on an officer of the company for contravention should be kept, but it is proposed to remove the penalty on the company, and the provision that the purported acquisition is void.

Question 65  Do you agree that the existing exceptions to the general rule that a company may not acquire its own shares should be retained, but that the company should no longer be liable to penalties for contravening the ban, and that acquisitions which contravene the ban should no longer be void?

3.38  It will be necessary to retain for public companies the substance of the provision deeming a person acquiring the shares of a company as a nominee of that company to be acquiring them on his own behalf (*CA1985*, section 144). This implements for public companies Article 18.2 of the Second Directive, and it is proposed to retain it for private companies too. There are certain exceptions in *CA1985*, section 145. Section 145(2)(b), concerning shares issued in consequence of an application made before 22 December 1980 appears to be spent. Otherwise, the substance of section 145 would remain, as would the substance of *Part I of Schedule 2*, defining a beneficial interest.

3.39  *CA1985*, section 146 provides for the disposal or cancellation by public companies of shares acquired in various ways other than by redemption or repurchase. It implements Article
20.2 of the Second Directive. It is proposed to retain the substance of this provision. It is for consideration whether to take advantage of the option given to companies in Article 20.2 not to cancel shares if these do not exceed 10% of the company’s subscribed capital. It should, as now, be provided that a company may cancel shares under this provision without going through the procedure for capital reduction (CA1985, section 147(1)). CA1985, section 147(2)-(4) deals with the case where a public company reregisters as private; these will be dealt with separately, along with the reregistration provisions in Part II of the Act). It is proposed to retain the substance of CA1985, section 148, which deals with the case where a private company acquires its own shares and reregisters as public before they are cancelled or disposed of.

Question 66  Do you favour taking advantage of the freedom given by the Second Directive to exempt from cancellation shares acquired other than by redemption or purchase, so long as these shares do not represent more than 10% of the company’s subscribed capital?

Question 67  Do you agree that the substance of section 148 should be retained?

3.40 It is proposed to retain the penalties on an officer of the company for failure to cancel or dispose of shares, or to reregister a public company as private, under section 146, but to drop penalties on the company (CA1985, section 149). It is necessary, in order to comply with Article 24 of the Second Directive, to retain for public companies the substance of the provision that acceptance of the shares of a company as security, whether by the company itself or by someone acting on its behalf, counts as an acquisition of the shares (CA1985, section 150). There are exceptions for companies whose ordinary business is the lending of money or the provision of credit, and for the case where a company other than a public company accepts its own shares as security and later reregisters as a public company. It is for consideration whether it is any longer necessary to retain the transitional provision for “old” (pre-1980) public companies (CA1985, section 150(1)).

Question 68  Do you agree that where shares are not cancelled or disposed of as required, the penalty on the company should be dropped?
Question 69  Do you think that a provision on the lines of that in section 150(4) for “old” (pre-1980) public companies is any longer needed?

Financial Assistance by a Company for the Acquisition of its own Shares

3.41 As noted in the Strategic Consultation Document, financial assistance is normally regarded as part of the capital maintenance regime, although transactions involving financial assistance do not in fact diminish a company’s share capital. Article 23 of the Second Directive requires us to maintain a prohibition on financial assistance by public companies, subject to limited exceptions; but there is no external requirement on us to maintain a prohibition, or restrictions, on financial assistance by private companies. There is an argument in the case of private companies that the extent to which existing shareholders have a say in decisions to give financial assistance can be left to the Articles; and that such assistance can only endanger the interests of creditors in a situation of potential insolvency, when the directors’ duties and the provisions on fraudulent and wrongful trading are likely to be relevant. It is therefore for consideration whether the rules on financial assistance should continue to apply to private companies. This will be considered further in the general context of the regime applicable to small and private companies, but we would welcome views at this stage.

Question 70  Do you favour removing entirely from private companies the prohibition on giving financial assistance for the acquisition of a company’s own shares?

3.42 We have assumed for present purposes that the complete removal of the ban on financial assistance by private companies would be thought too radical. We have therefore based our proposals, for private and public companies, on the Department’s proposals of 1996 and 1997. The present law consists of provisions applying both to public and private companies (CA1985, sections 151-154); and provisions containing relaxations for private companies only – the so-called “whitewash” procedure (CA1985, sections 155-158). The most significant change proposed by the Department to the former was that the exception for the case where the company’s principal purpose in giving the assistance is not the acquisition of the shares (CA 1985, section 153(1)) should be reformulated in terms of the company’s “predominant reason”. The intention was to avoid the narrow interpretation placed on the former wording by the House of Lords in
the Brady case\(^2\). The proposal was widely supported in consultation at the time. However, it is arguable that companies giving financial assistance almost always have some ulterior motive. Some of these are entirely legitimate commercially (to facilitate venture capital investment) or socially (to promote wider ownership of the company’s shares); others are more doubtful (to promote a supporters’ club to help resist a takeover). It is for consideration whether a variant on the principal purpose test would achieve the aim of permitting innocent transactions while catching the others.

**Question 71** Do you think that the objective of the “principal purpose” exception in section 152(2)(a) could be achieved by a reformulation, without undermining the rationale of the prohibition on financial assistance? If so, what reformulation would you suggest?

3.43 The other changes to these sections suggested by the Department were:

a) to clarify the prohibition on financial assistance by a subsidiary to ensure that assistance by the foreign subsidiary of a British company is not caught (*CA1985, section 151(1)*);

b) to remove unlimited companies from the scope of the prohibition (subject to certain safeguards);

c) to replace the present prohibition on “assistance” given after the event (*CA1985, section 151(2)*), which is not conditional on there having been a prior understanding as to the finance being made available for that purpose, with a prohibition on entering an agreement or understanding with a third party that if he acquires the company’s shares he will be reimbursed;

d) that the sanction against an officer of the company for breach of the prohibition should remain, but the sanction against the company be removed (*CA1985, section 151(3)*);
e) that, in order to provide comfort to banks and others reluctant to become involved in transactions which might, even remotely, involve financial assistance, transactions in breach of the prohibition should no longer be void for that reason alone;

f) there should be a new exception for payments of commissions, fees and indemnities and warranties for underwriting share issues;

g) there should be a new exception for financial assistance for a transaction which is itself the subject of an exception under section CA1985, section 153(3) and (4); and

h) the exception for financial assistance for the purpose of an employee share scheme would be widened to cover transactions between employees or an employee trust and an outside investor (CA1985, section 153(4)(bb)).

It is intended to reflect these proposals in legislation resulting from the Review. It is also proposed that for private companies there should be a new exception for financial assistance for arrangements bone fide made to facilitate the transfer of shares by members of the company in circumstances where there would otherwise be difficulty in matching buyers with sellers. Such an exception may not be needed if the Chapter is disapplied to private companies.

Question 72 Do you agree:

i) that it should be made clear that the prohibition on financial assistance does not apply to assistance given by the foreign subsidiary of a British company;

ii) that the prohibition on financial assistance should not apply to unlimited companies;

iii) that the prohibition in section 151(2) on financial assistance given after the event should be replaced by a provision on the lines of that suggested paragraph 3.43 at c);
iv) that the sanction on the company for breach of the prohibition should be removed;

v) that a new exception should be introduced for the payment of commission, fees, indemnities and warranties for underwriting shares issues;

vi) that transactions in breach of the prohibition should no longer be void for that reason alone;

vii) that a new exception should be introduced for financial assistance for a transaction which is itself the subject of an exception;

viii) that the exception in section 153(4)(bb) should be extended to cover transactions between employees or an employee share trust and an outside investor; and

ix) that there should be a new exception, for private companies only, for financial assistance to facilitate transfers of shares between members of a company where there is difficulty matching buyers and sellers?

3.44 For private companies, the present “whitewash” procedure has the following elements:

- the assistance must not reduce net assets – or, if it does, it must be provided out of distributable profits;

- the assistance must be approved by special resolution;

- the directors must make a statutory declaration of solvency;

- the solvency declaration must be supported by an auditors’ report; and

- shareholders opposed to the statutory resolution may apply to the court to have it annulled.
3.45 The Department proposed a radical relaxation, as follows:

- assistance which did not “materially prejudice” the company (defined as assistance provided out of distributable profits and which reduces net assets by less than 3%) would be permitted freely;

- where this test was not met, a special resolution would be required; and

- there would be no requirement for a solvency declaration, and no special minority protection.

3.46 The Strategic Consultation Document put forward an alternative approach:

- there would be no “de minimis” exclusion for assistance which did not materially prejudice the company;

- approval would be by ordinary resolution, but shareholders interested in the transaction would be disenfranchised;

- a formal declaration of solvency (but not a statutory declaration) would be required;

- there would be no requirement for “cover” by distributable profits; and

- there would be no special minority protection.

3.47 Having considered the matter, we should now like to propose the following elements for a simplified “whitewash” procedure:

- approval would be by ordinary resolution, but shareholders interested in the transaction would be disenfranchised;

- the assistance must not reduce net assets by 3% or more, or, failing that:

- it must be provided out of distributable profits, or, failing that;

- it must be supported by a solvency declaration by the directors; and

- there would be no special minority protection.
The provision now made by \textit{CA1985, section 155} would be recast to reflect these elements.

**Question 73** Do you favour the reform of the "whitewash" procedure for private companies? If so, do you favour the reforms outlined in paragraph 3.47; or those proposed in the Strategic Consultation Document; or those proposed earlier by the Department; or some other reforms?

3.48 The solvency declaration would be a formal statement, but the requirement for a statutory declaration would be dropped, as elsewhere in the new legislation. The content of the declaration would remain substantially the same \textit{(CA1985, section 156(2))}. It is suggested that (in a case where a company has auditors, but not otherwise) this declaration should be accompanied by a report from the auditors to the effect that they have enquired into the state of the company and are not aware of anything to indicate that the opinion expressed by the directors in the solvency declaration is unreasonable in all the circumstances. The solvency declaration and the auditors’ report (if any) would be available for inspection at the meeting at which the resolution was proposed \textit{(CA1985, section 157(4)(a))}. The ordinary resolution would be delivered to the registrar within 15 days of being passed, along with the solvency declaration and the auditors’ report (if any) \textit{(cf. CA1985, section 156(5))}. There would be penalties for making a declaration without reasonable grounds \textit{(CA1985, section 156(7))}. It is proposed that the present strict timing requirements should, where applicable, be retained. The company would thus be required to pass the resolution within a week of the date of the solvency declaration \textit{(CA 1985, section 157(1))}; and to give the assistance within eight weeks of the date of the solvency declaration \textit{(CA1985, section 158(4))}.

**Question 74** Do you think that the directors’ solvency declaration on the provision of financial assistance by a company for the acquisition of its own shares should be supported by an auditors’ report?

**Question 75** If so, do you agree that the auditors should report in the terms suggested in paragraph 3.48?

**Question 76** Do you agree that companies with no auditors should be exempt from a requirement for an auditors’ report?
Question 77 Do you favour the other provisions in paragraph 3.48 on procedure and timing?

Redeemable Shares: Purchase by a Company of its own Shares

3.49 Chapter VII of Part V of CA1985 makes provision for companies to redeem shares issued as redeemable shares, and to repurchase shares whether or not they were issued as redeemable shares. The Chapter implements for public companies the relevant Articles of the Second Directive. Some of the provisions are specific either to the redemption of redeemable shares or to the purchase of own shares; others are common to both.

Provisions Specific to the Redemption of Redeemable Shares

3.50 It is proposed to retain the statutory authority for the issue by companies of redeemable shares (CA1985, section 159(1)). As now, the timing of redemption may be fixed in advance, or may be at the option of the company, the holder or both, whether during a predetermined period or otherwise. It is also proposed to retain the present requirements that redeemable shares may not be issued where a company has no shares in issue that are not redeemable (CA1985, section 159(2)). This avoids the risk that on redemption the company will be left with no shares. It may however be that the prohibition can be better expressed as a requirement that a company must always have some shares which are not redeemable. This would, for example, prohibit a capital reduction involving cancellation of all of a company’s non-redeemable shares (see also paragraph 3.52 below). The terms of redemption must be provided for in the company’s Articles (CA1985, section 160(3)); and these must provide for payment on redemption (CA1985, section 159(3)).

Question 78 Do you agree that the statutory authority for the issue of redeemable shares should be retained?

Question 79 Do you think that the provision in section 159(2) could be more simply expressed as a requirement that a company must always have some shares which are not redeemable?
3.51 **CA1985, section 159A** was enacted in 1989 to replace section 160(3) in an attempt to give directors more leeway over the timing of redemption and the amount payable on redemption. Further consultation revealed that the section would not work as intended and it has never been commenced. It is proposed to drop this section and to retain provision on the lines of section 160(3). It is however for consideration whether private companies, who are not bound by the Second Directive, should be free to issue redeemable shares without the terms of redemption being included in their Articles (constitution). The absence of this facility was identified as an irritant in the Strategic Consultation Document.

**Question 80** Do you agree that provision on the lines of section 160(3) should be retained? Or should we attempt to give companies greater flexibility by attempting a reformulation of section 159A, and if so how?

**Question 81** Should we free private companies entirely from the requirement that the terms of redemption should be specified in the company’s constitution (Articles)?

**Provisions Specific to Purchase of own Shares**

3.52 It is proposed to retain the basic provision enabling a company, subject to the provisions of the Chapter, to purchase its own shares – including any redeemable shares purchased ahead of time (**CA1985, 162(1)**). A company would not however be permitted to purchase its own shares if as a result the only shares outstanding were redeemable shares (**CA1985, section 162(3)**). As with section 159(2), the aim is to prevent a company being left with no shares.

3.53 **CA1985, sections 163-167** make detailed provision for the authority which the directors must obtain from the shareholders before undertaking a purchase of own shares. These are different depending on whether the purchase is on – or off-market. It is proposed to maintain this distinction and to keep the substance of the necessary definitions in **CA1985, section 163**.

3.54 The safeguards for the shareholders in the case of an off market purchase need to be strict since there is no independent check on the reasonableness of the price. The purchase contract must be approved in advance by special resolution, which must have been available for
inspection, and the authority given by the resolution must expire no more than eighteen months later (CA1985, section 164). Similar requirements apply to a contingent purchase contract (CA1985, section 165). It is proposed to retain the substance of these provisions.

Question 82 Do you agree that the substance of the present provisions relating to authority for an off market purchase, and for a contingent purchase contract, should be retained?

3.55 It is also proposed to retain the somewhat less demanding requirements for authority of a market purchase of own shares. Here, advance authority must be given by ordinary resolution, which must specify the maximum number of shares to be purchased, the maximum and minimum prices, and the date at which the authority expires (CA1985, section 166). It is also proposed to maintain the ban on the assignment by the company of a contract for the purchase of own shares (CA1985, section 167(1)); and the requirement that an agreement by the company to release its rights under a contract for purchase of own shares previously approved must be endorsed by special resolution (CA1985, section 167(2)).

3.56 It is proposed to retain the requirement that payments in consideration for the acquisition of a right to purchase own shares, the variation of an approved purchase contract and the release of any of the company’s obligations in respect of a purchase of own shares must be made out of distributable profits (CA1985, section 168(1)). If this requirement is not satisfied, then the purchase in the first two cases is, as now, to be unlawful, and in the third case the release is to be void (CA1985, section 168(2)). This follows logically from the provision in CA1985, sections 160(1) and 162 for the financing of the redemption or purchase of own shares (see paragraphs 3.58-59).

Question 83 Do you agree that the substance of the present provisions in sections 166, 167 and 168, relating to authority for a market purchase, to the assignment or release of a company’s right to purchase own shares and to payments apart from the purchase price, should be retained?
3.57  **CA1985, section 169** contains disclosure provisions specific to the purchase of own shares. The minimum requirements of the Second Directive, for public companies, are met elsewhere in the present legislation – section 122 on the disclosure of changes in share capital, and Part II of Schedule 7 on the directors’ report. Our provisional view, on which we would welcome comments, is that there is no need to retain the additional provisions of section 169, which include a requirement to keep a copy of the contract available for inspection for ten years, and which are particularly onerous for public companies. The point will however be examined elsewhere in the Review, in the context of disclosures at Companies House.

**Question 84**  Do you think that the disclosure provisions in section 169 need be retained, given the existence of other relevant disclosure provisions in the legislation?

**Provisions Common to the Redemption of Redeemable Shares and the Purchase of Own Shares**

3.58  We propose to maintain the provision that shares may not be redeemed or repurchased unless they are fully paid (**CA1985, section 159(3), as applied to purchase of own shares by section 162(2)**). This is a requirement of the Second Directive for public companies and safeguards share capital against depletion if partly paid shares were redeemed in full.

3.59  To the extent that par value shares remain, it is proposed to retain the provision that shares may only be redeemed, or own shares purchased, out of distributable profits or out of the proceeds of a new issue; and that any premium (over nominal value) must be paid out of distributable profits (**CA1985, section 160(1), as applied to purchase of own shares by section 162(2)**). As now, this requirement would be relaxed where the shares concerned were issued at a premium. (**CA1985, section 160(2), as applied to purchase of own shares by section 162(2)**). It is proposed to make parallel provision for NPV shares by requiring that they must be redeemed or purchased by the company from the proceeds of a new issue or, failing that, from distributable profits.

**Question 85**  Do you support the proposals in paragraphs 3.58-59?
3.60  *CA1985, section 160(4)* requires that redeemable shares be treated as cancelled on redemption. This is extended by *CA1985, section 162(2)* to own shares, including redeemable shares, purchased by the company. Proposals are outstanding from the Department to permit companies, instead of cancelling shares on purchase, to hold up to 10% of their issued share capital in treasury for subsequent resale. The redemption of redeemable shares, according to the terms of issue, logically implies cancellation, and companies would not therefore be enabled to hold redeemable shares in treasury beyond the redemption date. If the Department’s proposals are implemented in the near future, it is proposed to reflect them in the legislation resulting from the Review. Where shares are cancelled on redemption or purchase by the company, it is proposed to retain the requirement (*CA1985, section 160(4)*) that the nominal values of the company’s share capital must be reduced accordingly, where the shares have a nominal value. In the case of NPV shares, cancellation of shares following a redemption or repurchase leaves the quantum of subscribed share capital unchanged – it is merely represented by fewer shares.

3.61  It is proposed to retain, for the case where par value shares are redeemed or purchased by the company and cancelled, the substance of *CA1985, section 170*, which requires the creation of a capital redemption reserve. Where the redemption or purchase is wholly out of profits, the whole amount by which issued share capital is reduced would, as now, be transferred to capital redemption reserve (*CA1985, section 170(1)*). Where the redemption or purchase is wholly or partly out of the proceeds of a new issue, the amount transferred to capital redemption reserve would be the excess of the nominal value of the shares redeemed or purchased over the proceeds of the new issue (*CA1985, section 170(2)*). The present provision on the application of the capital redemption reserve would be retained (*CA1985, section 170(4)*). (For NPV shares, the question of reducing (nominal) share capital and increasing a capital redemption reserve would not of course arise.)

3.62  In view of the proposal to introduce a much simplified procedure for capital reduction by private companies (see paragraphs 3.27-35 above) it is not proposed to retain the special provisions enabling private companies to redeem or purchase their own shares out of capital (*CA1985, sections 171-177*).
Question 86 Do you agree that, in view of the proposal to relax the procedure for the reduction of capital by private companies, it is no longer necessary to retain the special provisions enabling private companies to redeem or purchase shares out of capital?

3.63 It is proposed to retain the substance of the existing provision setting out the rights of a shareholder where a company fails to redeem his shares in accordance with their terms of issue, or fails to purchase his shares in accordance with a contract to do so (CA1985, section 178). It is proposed to consider the power to modify the provisions of this Chapter later in the Review, in the context of other similar order making powers (CA1985, section 179).

3.64 It is for consideration whether it is still necessary to retain provision for cases transitional when the main provisions of this Chapter were introduced in 1981 (CA1985, section 180). It is proposed to retain a definition of “distributable profits”, by reference to the statutory rules on distributions (see below). With the disappearance of the provision for redemption or purchase out of capital by private companies, it will no longer be necessary to define the “permissible capital payment” (CA1985, section 181).

Question 87 Do you see any need to retain the provisions in section 180 for cases transitional in 1981?

Distribution of Profits and Assets

Provisions Applicable to Private and Public Companies

3.65 It is proposed to maintain the main substance of the distribution rules now set out in Part VIII of CA1985, for both private and public companies. The main rule, applicable to all companies, will continue to be that distributions may only be made out of profits available for the purpose (CA1985, section 263(1)). The definition of “distribution” will continue to include any distribution of assets to the members, whether in cash or otherwise, subject to a number of exceptions (CA1985, section 263(2)). However, issues on the definition of realised profits, and on the valuation of liabilities and the net assets test, together with other matters concerning the relationship between
the accounts, accounting standards and the distribution rules, are under consideration in Working Group G, the Group covering accounting and reporting. We are expecting to consult on these issues early next year.

3.66 But we propose to add to the definition that a distribution for the purpose of this part of the legislation will be a distribution of assets to members in their capacity as members. Thus the transfer of company assets to a person would not be subject to challenge under the statutory distribution rules merely because that person happened to be a member of the company. This clarification of the concept of a “distribution” would also deal with a widely perceived problem to which the case of Aveling Barford v Perion Ltd 1989 BCLC 626 appears to have given rise. Problems were seen with the application of the accounting provisions of Part VIII of the Companies Act to such transactions. As the latter would not be within the proposed definition of a “distribution”, the perceived problems would appear to fall away. There remains the common law rule that a company cannot, without the leave of the court or the adoption of a special procedure such as winding up, return its capital to shareholders. The rule originated in the 19th century but is now generally regarded as applying to any payment by the company, or transfer of its assets, to a shareholder or an associate of a shareholder, other than by way of lawful dividends, reductions of capital or other lawful procedures. Thus it can cover matters such as the sale of company assets at an undervalue or the payment of remuneration to a director out of all proportion to the services rendered by that director. Since the 19th century newer remedies have been developed to deal with transactions of this nature. In addition to the clawback provisions of insolvency law, such as the right to challenge transactions at an under value (Insolvency Act 1986 section 238 and the Scottish equivalent section 242), the law relating to director’s duties has now embraced the concept of the director’s duties to a company as including an obligation to have regard to the interests of the creditors where the company is insolvent or potentially insolvent. It seems appropriate, therefore, for the role of the common law rules on return of capital to be reviewed in the context of the work of the Review on directors’ duties which, are highly relevant to controlling the type of transaction described. It is however for consideration whether the law should be simplified and clarified by providing that Part VIII is to have effect in place of any rule of law prohibiting distribution as such, but without prejudice to the general fiduciary duties and duties of care and skill of directors, or to provisions in an enactment or in
the company’s constitution. (This would in effect partially reverse the position under CA1985, section 281.)

Question 88 Do you agree that the legislation should make clear a) that the distribution rules apply only to distributions to members in their capacity as members, and b) that the distribution rules have effect in place of any rule of law prohibiting distribution as such, but without prejudice to the general fiduciary duties and duties of skill and care as well as to provisions in an enactment or in the company’s constitution?

3.67 The following would continue to be excluded from the definition of a distribution for the purpose of these provisions; an issue of fully or partly paid bonus shares; a redemption or purchase of own shares out of unrealised profits (the reference to redemption or purchase out of capital will fall with the provision for a private company to redeem or purchase own shares out of capital – see paragraph 3.62 above); a reduction of capital duly made, whether by paying off fully paid shares or reducing the liability on partly paid shares; and a distribution to members on winding up (CA1985, section 263(2)).

Question 89 Do you agree that the list of exclusions from the definition of a “distribution” currently in section 262(2) should in substance be retained?

3.68 It is provisionally proposed to retain the present definition of “profits available for distribution”, subject to separate examination in the Review of the statutory and non-statutory accounting rules (CA1985, section 263(3)).

3.69 It is proposed to retain the provision that a company may not apply an unrealised profit in paying up debentures or amounts unpaid on shares (CA1985, section 263(4)). The provision for profits made before December 1980 is assumed to be spent (CA1985, section 263(5)).

Question 90 Do you agree that the prohibition on the application of an unrealised profit in paying up debentures or amounts unpaid on shares should be retained?

Question 91 Do you agree that the provision in section 163(5) is spent?
3.70 The provision on the treatment of development costs when calculating distributable profits \((CA1985, \text{section 269})\) will be examined separately in the course of the work of the Review on the statutory requirements relating to company accounts and accounting. Provisions will be needed specifying the accounts by reference to which distributable profits are to be calculated \((CA1985, \text{sections 270-276})\). The detail of these provisions, and their adaptations for \textit{banking and insurance companies} \((CA1985, \text{section 279 and Schedule 11})\) will also be examined in the course of the work of the Review on accounts and accounting.

3.71 It is proposed to retain the provision requiring a member who receives a distribution which he knows to be unlawful to repay it \((CA1985, \text{section 277})\); whether an officer of the company responsible for making an unlawful distribution should be made liable to penalties will be examined separately in the Review in the general context of penalties.

\textbf{Question 92} Do you agree that we should retain the provision requiring a member who receives a distribution knowing it is unlawful to repay it?

3.72 It is for consideration whether it is necessary to retain the saving for provisions in company Articles operative before 1980, enabling bonus shares to be paid up out of unrealised profits \((CA1985, \text{section 278})\). It is proposed to retain the definitions of “capitalisation” and “profits” insofar as the terms are used in the new legislation \((CA1985, \text{section 280})\). 

\textbf{Question 93} Do you think that it is necessary to retain the saving in section 278 for Articles operative before the Act of 1980?

\textbf{Provisions Applicable to Public Companies}

3.73 In order to comply with Article 15 of the Second Directive, the freedom of a public company to make distributions is restricted by reference not only to its distributable profits but also to its net assets \((CA1985, \text{section 264})\). It is proposed to retain the broad thrust of this section. But the reference to the Memorandum will go as a result of our proposals on company formation \((CA1985, \text{section 264(3)})\). It is also proposed to retain the provision that uncalled share capital may not be counted as an asset for the purpose of the calculation required by this section \((CA1985, \text{section 264(4)})\).
Question 94  Do you agree with the proposals in paragraph 3.73?

Provisions Applicable to Investment Companies

3.74  It is proposed to retain the provisions relaxing the terms of sections 263 and 264 for investment companies (CA1985, section 265) and defining the investment companies to benefit from the relaxation (CA1985, section 266). The power to extend definition of an investment company for this purpose will be considered separately in the Review along with other similar powers (CA1985, section 267).

3.75  Proposals are outstanding from the Department to relax the rules for investment companies further by permitting them to use capital profits for the sole purpose of buying back or redeeming their shares in accordance with Chapter VII of Part V of CA1985 If these proposals are enacted, it is proposed to reflect them in the legislation resulting from the Review.

Provisions Applicable to Insurance Companies

3.76  It is intended to retain the substance of the present provisions adapting the definition of “realised profit” and “realised loss” for insurance companies with long term business (CA1985, section 268).
Company Formation and Related Matters

1. Do you agree with the proposal in paragraph 2.4 for defining who are the founder members of the company?

2. Do you think that the relationship between the company and its members, and between the members themselves, is adequately defined by the present section 14(1)? Specifically, does it help to characterise these relationships as contractual? And should the relationships created by the constitution extend to the directors and officers of the company?

3. Do you agree that a debt owed by a member to the company should no longer be a specialty debt?

4. Do you agree that the three existing types of company should be retained (without prejudice to the possibility of creating additional types)?

5. Do you agree that a public and a private company should be defined as suggested in paragraph 2.10?

6. Do you agree that it should be possible to form any type of company as a single member company?

7. Do you agree that the requirement that a company be formed for a lawful purpose should be retained?

8. Do you agree that, for newly formed companies, the Memorandum and Articles of Association should be replaced by a constitution in a single document, accompanied by a standard Registration Form?

9. Do you agree that existing companies should not be required to reregister, but that transitional arrangements on the above lines should be worked out?

10. Should the right to apply to the court to cancel an alteration to the Memorandum be retained?
11. Do you agree with the proposals in paragraphs 2.16-18 for the content of the new Registration Form?

12. Do you agree that for private companies the requirement to have objects should be dropped?

13. Do you agree that the option of registering the objects of a “general commercial company” should be withdrawn, with appropriate savings for companies already formed with such objects?

14. Do you agree that the new Registration Form should be signed by the first director(s) and secretary, whose particulars would be included?

15. Do you agree that the director(s) should confirm that they have read a statement of their duties as directors?

16. Do you agree that a power as described in paragraph 2.20 should be provided?

17. Do you agree with the proposals in paragraph 2.21 on the content and signature of the company’s constitution?

18. Do you agree with these proposals to retain the substance of the present statutory provision for Table A and other model constitutions for companies of various types, but to drop the specific power to prescribe a model constitution for a partnership company?

19. Do you agree that the general rule should be that the constitution of a company should be amendable by special resolution, but that it should be open to the members to entrench provisions so that unanimity would be needed to change or remove them?

20. Do you agree with the proposals in paragraphs 2.28 and 2.29 on the publicity to be given to a company’s constitution?

21. Do you agree with the proposals in paragraphs 2.31 and 2.32 on the formation and registration of a company?
22. Do you agree with the proposals in paragraphs 2.33 and 2.34 on the effect of registration, including specifically the proposal to retain the conclusive effect of the incorporation certificate?

23. Do you agree that a company should henceforth have unlimited capacity, regardless of anything in its constitution, including its objects, but that a member should continue to be able to take proceedings to restrain the doing of an act contrary to the constitution?

24. Do you agree that in the case of charitable companies this should continue to be subject to the special provisions of charities law?

25. Do you agree with the proposals in paragraphs 2.37-40 relating to the powers of directors to bind the company, including specifically the proposal that special provisions should continue to apply to charitable companies?

26. Do you agree that the law relating to the powers of the directors to bind the company should be modified on the lines of the present section 322A where the other party is a director or a person connected to a director? Or should such persons simply be excluded from the protection given to third parties by the present section 35A?

27. Do you agree that deemed notice should be abolished, with the possible exception relating to the Register of Company Charges; and that the qualification that a person may be affected if he fails to make reasonable inquiries should be dropped?

28. Do you agree with the additional requirements set out in paragraph 2.44 for the constitution of a public company?

29. Do you agree with the proposals in paragraph 2.45 for the additional information on the Registration Form of a public company?

30. Do you agree that the registration of a newly formed company as a public company should henceforth be a single stage process?

31. Do you agree that the incorporation certificate of a public company should have conclusive effect?
Capital Maintenance

32. Do you agree that provisions limiting the giving of commissions and discounts out of capital on the issue of shares should no longer apply to private companies (regardless of your views on no par value shares – see below) ?

33. Do you agree that for public companies it is no longer necessary to preserve the power to pay "such brokerage as has previously been lawful" ?

34. Do you agree that for private companies it should no longer be possible to issue par value shares, and that existing par value shares should be deemed to have no par value?

35. Do you agree that for private companies, the rule against allotting shares at a discount should be replaced by a rule that the consideration for newly issued shares, net of any commission or discount, should equal the amount credited to subscribed share capital?

36. Do you agree with the modifications and simplifications proposed in paragraph 3.10?

37. Do you agree with the modifications and simplifications proposed in paragraph 3.11?

38. Do you agree that section 119 can be omitted as superfluous?

39. Do you agree that the power of a company to modify its share capital (other than by reducing it) should be retained with the modifications described in paragraph 3.13?

40. Do you agree that the registration requirements for a modification of capital should be retained, with the modifications suggested in paragraph 3.14?

41. Do you agree that the penalty on the company for breaches of the registration requirements for a modification of capital should be dropped?

42. Given the intention to abolish authorised share capital, do you think that the need for disclosure of share allotments is adequately met by section 80, supplemented, in the case of shares with special rights, by section 128(1) ?
43. Do you agree that it is no longer necessary to make provision for long term uncalled capital, whether of limited or unlimited companies?

44. Do you think that it is necessary to preserve the present provisions for long term uncalled capital for existing companies?

45. Do you think that the present minimum allotted capital for public companies of £50,000 should be increased, reduced or stay the same?

46. Do you think that the provisions in section 118(2)(b) and (c) on the content of an order increasing the authorised minimum could be simplified and made more general?

47. Do you agree that on an issue of shares the company’s undistributable reserves should be increased by the net proceeds?

48. Assuming that par value shares are abolished for private companies, do you agree that neither the company’s initial expenses, nor commission or discount paid on the issue of other shares, nor the premium payable on the redemption of debentures, should be deductible from the amount transferred to subscribed capital?

49. For public companies, do you agree that the three items referred to in Question 48 should be excluded from the permitted applications of share premium account?

50. For private companies, assuming the abolition of par value shares, do you favour a) the abolition of merger relief, or b) the alternative suggestion outlined above, or c) some other alternative.

51. For public companies, do you favour a) the abolition of merger relief, or b) its retention in its present form, or c) some other alternative?

52. For private companies, assuming the abolition of par value shares, do you support the retention of relief in respect of group reconstructions in the modified form suggested in paragraph 3.24?

53. Do you favour the retention of such relief in its present form for public companies?
54. Do you agree that the substance of section 133 should be retained?

55. Do you agree that the requirement on companies to seek court approval for a reduction of capital should end?

56. Do you agree that it should be replaced by a decision of the company by special resolution, backed by a solvency statement by the directors, with, in the case of public companies only, a right of creditors to object to the court?

57. Do you agree that the list in section 135(2) of types of capital reduction should be retained, with the modification suggested in paragraph 3.28?

58. (a) Do you think that the directors’ solvency declaration on a reduction of share capital should be supported by an auditors’ report?

   (b) If so, do you agree that the auditors should report in the terms suggested?

   (c) Do you agree that companies with no auditors should be exempt from a requirement for an auditors’ report?

59. Do you think that capital reductions which would create an undistributable reserve of not more than 10% of the reduced capital should be exempt from the procedures proposed in paragraph 3.31?

60. Do you agree with the proposals in paragraph 3.31 relating to the grounds on which a creditor might object, and to the time limit for objections?

61. Do you agree that creditors found to have no reasonable grounds for objecting to a capital reduction should be liable at the court’s discretion for some or all of the company’s costs?

62. Do you agree with the proposals for publicity in paragraph 3.32 for a proposed capital reduction, including the liability of directors and the rights of creditors if a company defaults on its obligations?
63. Do you agree that the present section 139 should be replaced by a simple prohibition against a public company reducing its capital below the authorised minimum?

64. Do you support the proposals in paragraphs 3.34 and 3.35?

65. Do you agree that the existing exceptions to the general rule that a company may not acquire its own shares should be retained, but that the company should no longer be liable to penalties for contravening the ban, and that acquisitions which contravene the ban should no longer be void?

66. Do you favour taking advantage of the freedom given by the Second Directive to exempt from cancellation shares acquired other than by redemption or purchase, so long as these shares do not represent more than 10% of the company’s subscribed capital?

67. Do you agree that the substance of section 148 should be retained?

68. Do you agree that where shares are not cancelled or disposed of as required, the penalty on the company should be dropped?

69. Do you think that a provision on the lines of that in section 150(4) for “old” (pre-1980) public companies is any longer needed?

70. Do you favour removing entirely from private companies the prohibition on giving financial assistance for the acquisition of a company’s own shares?

71. Do you think that the objective of the “principal purpose” exception in section 152(2)(a) could be achieved by a reformulation, without undermining the rationale of the prohibition on financial assistance? If so, what reformulation would you suggest?

72. Do you agree:

   i) that it should be made clear that the prohibition on financial assistance does not apply to assistance given by the foreign subsidiary of a British company;

   ii) that the prohibition on financial assistance should not apply to unlimited companies;
iii) that the prohibition in section 151(2) on financial assistance given after the event should be replaced by a provision on the lines of that suggested at paragraph 3.43(c);

iv) that the sanction on the company for breach of the prohibition should be removed;

v) that a new exception should be introduced for the payment of commission, fees, indemnities and warranties for underwriting shares issues;

vi) that transactions in breach of the prohibition should no longer be void for that reason alone;

vii) that a new exception should be introduced for financial assistance for a transaction which is itself the subject of an exception;

viii) that the exception in section 153(4)(bb) should be extended to cover transactions between employees or an employee share trust and an outside investor; and

ix) that there should be a new exception, for private companies only, for financial assistance to facilitate transfers of shares between members of a company where there is difficulty matching buyers and sellers?

73. Do you favour the reform of the “whitewash” procedure for private companies?
If so, do you favour the reforms outlined in paragraph 3.47; or those proposed in the Strategic Consultation Document; or those proposed earlier by the Department; or some other reforms?

74. Do you think that the directors’ solvency declaration on the provision of financial assistance by a company for the acquisition of its own shares should be supported by an auditors’ report?

75. If so, do you agree that the auditors should report in the terms suggested in paragraph 3.48?
76. Do you agree that companies with no auditors should be exempt from a requirement for an auditors’ report?

77. Do you favour the other provisions in paragraph 3.48 on procedure and timing?

78. Do you agree that the statutory authority for the issue of redeemable shares should be retained?

79. Do you think that the provision in section 159(2) could be more simply expressed as a requirement that a company must always have some shares which are not redeemable?

80. Do you agree that provision on the lines of section 160(3) should be retained? Or should we attempt to give companies greater flexibility by attempting a reformulation of section 159A, and if so how?

81. Should we free private companies entirely from the requirement that the terms of redemption should be specified in the company’s constitution (Articles)?

82. Do you agree that the substance of the present provisions relating to authority for an off market purchase, and for a contingent purchase contract, should be retained?

83. Do you agree that the substance of the present provisions in sections 166, 167 and 168, relating to authority for a market purchase, to the assignment or release of a company’s right to purchase own shares and to payments apart from the purchase price, should be retained?

84. Do you think that the disclosure provisions in section 169 need be retained, given the existence of other relevant disclosure provisions in the legislation?

85. Do you support the proposals in paragraphs 3.58-59?

86. Do you agree that, in view of the proposal to relax the procedure for the reduction of capital by private companies, it is no longer necessary to retain the special provisions enabling private companies to redeem or purchase shares out of capital?
87. **Do you see any need to retain the provisions in section 180 for cases transitional in 1981?**

88. **Do you agree that the legislation should make clear a) that the distribution rules apply only to distributions to members in their capacity as members, and b) that the distribution rules have effect in place of any rule of law prohibiting distribution as such, but without prejudice to the general fiduciary duties and duties of skill and care as well as to provisions in an enactment or in the company’s constitution?**

89. **Do you agree that the list of exclusions from the definition of a “distribution” currently in section 262(2) should in substance be retained?**

90. **Do you agree that the prohibition on the application of an unrealised profit in paying up debentures or amounts unpaid on shares should be retained?**

91. **Do you agree that the provision in section 163(5) is spent?**

92. **Do you agree that we should retain the provision requiring a member who receives a distribution knowing it is unlawful to repay it?**

93. **Do you think that it is necessary to retain the saving in section 278 for Articles operative before the Act of 1980?**

94. **Do you agree with the proposals in paragraph 3.73?**
Sections 1-6  Memorandum of Association

Section 1  Mode of forming incorporated company

Subsection (1). This lays down the basic requirements for the formation of an incorporated company. They are:

- there must be two or more founders; (This is modified by subsection 3A which permits a private company to be formed by one person.)
- the founders must be associated for a lawful purpose; (Subsection 3A provides that a single member private company must be formed for a lawful purpose.)
- the founders must subscribe their names to a Memorandum of Association;
- they must otherwise comply with the registration requirements of the Act; and
- the company formed may be with or without limited liability.

These are considered individually.

Two or more founders. The option of a single member company was extended to private companies only, since that was what the Twelfth Directive requires. It is considered that there would also be advantage in permitting a public company to be formed by a single person (which will of course include a legal person). It is therefore proposed to provide that any person (or persons) may form a company.

Association. Whether to retain the theory that the company is a consensual contract is discussed under sections 13 and 14 below. The question here is whether, where there are two or more founders, the requirement that they should be “associated” should be retained. It is thought not. It appears to do no more than is already required in that the two or more must act together. Whether and how this joint action is described is a matter of drafting.
Lawful purpose. This requirement at present serves two purposes. In theory it would enable the registrar to refuse to register a company in the unlikely event that its objects disclosed an unlawful purpose, or some other evidence came to his attention to that effect. However, it is proposed to remove the requirement for an objects clause, at least for private companies. But the present requirement also means that the declaration of compliance submitted by the founders when seeking the registration of a new company must confirm inter alia that the company is being formed for a lawful purpose (see below under section 10). It will be an offence to make a false or reckless declaration. It is therefore proposed to retain the “lawful purpose” requirement.

Subscription. In the case of a public company, Article 3(i) of the Second Directive requires disclosure of the identity of the persons by whom the statutes or instrument of incorporation have been signed.

Compliance with (other) registration requirements. This will stay.

With or without limited liability. Since subsection (2) lists the available types of company exhaustively, this is superfluous even now.

Subsection (2). This lists the three types of company that may be formed – a company limited by shares, a company limited by guarantee and an unlimited company. Subject to further work on possible new corporate vehicles for small businesses, it is intended to retain these three types only. But the definitions of the first two refer to liability being limited “by the Memorandum”. The effect of the words “by the Memorandum” is to prevent the limited character of the company being changed – this not being a provision of the Memorandum which could be altered except by reregistration. Since it is proposed to abolish the Memorandum, references to the Memorandum will be dropped. (But it is proposed that one of the items of basic information to be given on the new Registration Form will be the type of company, and this will be alterable only by reregistration; see below under section 10(2).)

The existing definitions of the company limited by guarantee and the unlimited company can in substance stand. So can that of the company limited by shares if it is decided to retain partly paid shares. However, if it was decided, as part of the reform of the capital maintenance provisions, to do away with partly paid shares, the words “the amount, if any, unpaid on the shares respectively
held by them” would not work. An alternative formulation in that case might be that the members have no liability as such except to pay the consideration for their shares.

Subsection (3). This defines a public company. It derives from the 1980 Act which provided for the first time for a separate category of “public company” in order to comply with the Second Directive. It applies to public companies whether newly formed or formed by re-registration of a private company (section 43). It also covers the possibility of the reregistration as a public company of a company limited by guarantee and having a share capital. (No new companies of that type could come into being after 22 December 1980 (see subsection (4).)

In line with the principle “Think small first” the present intention is to provide a basic set of provisions for private companies and a supplementary set for public companies. This implies that the definition of a public company, the provisions for the formation of a public company from scratch, and for the formation of a public company by reregistration, together with any associated registration provisions specific to public companies, should be separated off from the basic provisions relating to private companies and brought together in a separate part of the legislation. It will also be necessary to ensure that any definition of a public company covers both newly created companies and public companies created under the 1980 and 1985 Acts.

The definition of a public company, to be included in the appropriate place in the legislation, might therefore simply be a company registered or reregistered as such in accordance with the relevant provisions of the present Act or of previous Companies Acts. The reference to a company limited by guarantee with a share capital would be covered by the reference to previous Acts; and subparagraph (a), referring to the Memorandum, would disappear.

If the suggested restructuring of the legislation is accepted, and the term “private company” retained, it will be necessary to define “private company” in the “basic” block of legislation. It is therefore suggested that a private company should be defined as any company which has not been registered or reregistered as a public company; and a public company would be defined as a company registered or reregistered as a public company.

Subsection (3A). This implemented the Twelfth Directive on Single Member Private Companies. This will be subsumed in the revision of subsection (1).
**Subsection (4).** This transitional provision for companies limited by guarantee with a share capital is spent. The retention of the substance of section 15 (qv) will continue the prohibition on the creation of such companies in future.

**Sections 2-6.** These sections cover the form and content of the Memorandum of Association, and the procedures for altering it. It is proposed to abolish the Memorandum as such. But it is necessary to identify elements in these sections which will need to be reflected in a new guise in the new legislation. In doing so, it is necessary to take account of the requirements of the First and Second Directives.

The First Directive requires public disclosure of “the instrument of constitution”, and the “statutes” if contained in a separate document. The Second Directive requires, for public companies, disclosure in the “statutes or the instrument of incorporation”, of:

- the type and name of the company;
- the objects;
- the amount of subscribed capital. (There is no obligation to retain the concept of authorised capital, in addition to subscribed capital, and it is suggested that it should disappear. But if it is retained it must be disclosed); and
- the number appointment procedure and powers of the directors.

(It is assumed that the “instrument of constitution” and the “instrument of incorporation” are the same thing.)

Also to be disclosed by public companies, though not necessarily in the statutes or instrument of incorporation, are:
• the registered office;

• the nominal value of the shares subscribed and the number thereof;

• conditions limiting the transfer of shares;

• the above information separately for each class of shares where there are several;

• whether the shares are registered or bearer;

• the amount of share capital paid up at the time the company is incorporated or commences business;

• the identity of the signatories of the statutes or instrument of incorporation;

• the amount of formation costs incurred; and

• any special advantage granted to anyone taking part in the formation.

Provided a) that the above disclosure requirements are met by information given elsewhere, and b) that new form duly signed and registered (see below), constitutes an “instrument of constitution/incorporation”, there seems no bar to the abolition of the Memorandum as a separate document. It is a matter for discretion which of the specific disclosure requirements of the Second Directive are extended to private companies.

It is proposed that a single document – the Registration Form – will replace the Memorandum and other documents filed on formation (except the Articles if Table A is not adopted in full), and that the objects clause will disappear, for private companies at least. The proposed contents of this Form are set out in full under section 10, below.

Against that background, the essential requirements of sections 2-6 can be reflected in new legislation as follows.
Section 2: Requirements with respect to Memorandum

Subsection (1). The requirement for the Memorandum to state the name and jurisdiction of the company will be reflected in the new Registration Form. The requirement to state objects will disappear, at least for private companies. The option of stating the jurisdiction as “Wales” rather than “England and Wales” would also be exercised through the new Registration Form.

Subsection (2). If the proposal in the last sentence under subsection (1) is followed, it will be necessary to provide that a company with its registered office in Wales, and registered as having its registered office in England and Wales, may decide by special resolution to change the description of the jurisdiction to “Wales”, and for the registrar to amend the Form accordingly.

Subsection (3). (Memorandum of a company limited by shares or by guarantee to state the fact that the liability of members is limited). This information will be apparent on the face of the new Registration Form for a company of either type.

Subsection (4). (Memorandum of a guarantee company to state the liability of the members to contribute). This information can be required on the new Registration Form for a company limited by guarantee.

Subsection (5). Paragraph a) refers to the company’s authorised share capital on formation. It is proposed to abolish authorised, as distinct from issued, share capital. The amount of issued share capital (in each class of shares if there are several), its division into shares of fixed amounts (if par values are retained) and the number of shares held by each founder shareholder (paragraph 5(c)) will, it is proposed, be among the items of ephemeral information to be included on the Registration Form (see under subsection (7) below). Paragraph 5(b) (subscriber to take at least one share) will be implicit in the requirement that the Form be signed by all founder shareholders.

Subsection (6). (Signature of subscribers, to be witnessed). The provision for the new Registration Form should include a similar signature requirement. It is for consideration whether the witness requirement should remain.
Subsection (7). (Memorandum to be altered only as provided in the Act). It is suggested under section 10 below that two categories of information should be included on the Registration Form – a) basic information on matters which cannot be changed by decision of the company alone – eg type of company, jurisdiction, name, and b) ephemeral information about the company which will be updated by regular returns – eg names of directors and shareholders, and share capital. It will be made apparent by the Form that the ephemeral information is indeed ephemeral, so that those inspecting the register are not misled. It will not therefore be appropriate to provide a general procedure by which the company can decide on changes to be made to the Registration Form as submitted. (It will be necessary to ensure that when the name is changed, the register does not mislead.)

Section 3: Forms of Memorandum

Subsection (1). There will need to be a power for the Secretary of State to prescribe the new Registration Forms for companies of each type. Compliance with the prescription would be mandatory – not “as near as circumstances admit”. (For the prescription of model constitutions, see under section 8.)

Subsection (2). Negative resolution procedure seems appropriate for the power to prescribe the Form, but the content will be prescribed in the Act.

Section 3A: Statement of a company’s objects: general commercial company

It is hoped that the requirement for an objects clause can disappear for all types of company. Even if the requirement must be retained for public companies, the fact that, for third parties, the objects clause will have no effect should mean that the problem of prolix objects clauses is much reduced. In either case, this unsuccessful attempt to solve that problem can be dropped without replacement. This would be without prejudice to any objects clauses adopted under this section.
Section 4: Resolution to alter objects

Section 5: Procedure for objecting to alteration

Section 6: Provisions supplementing sections 4 and 5

If the requirement for an objects clause goes, these sections will fall automatically for newly incorporated companies. If objects clauses are retained for newly incorporated public companies, they will appear on the new Registration Form (but subject to new limitations on their significance – see below under section 35). It is proposed that provision should be made for any “new” objects clauses to be subject to amendment by special resolution without additional procedure. In view of the reduced significance of objects clauses, it is suggested that sections 4, 5 and 6 will not need preserving even for “old” objects clauses, but that these, too, should be amendable simply by special resolution.

Sections 7-9: Articles of Association

Section 7: Articles prescribing regulations for companies

Subsection (1). Provides for the registration of Articles of Association when a company is formed. The Articles are to be registered with the Memorandum and signed by the subscribers of the Memorandum. The Articles are described as “prescribing regulations for the companies”. In the case of an unlimited company, or a company limited by guarantee, there is an obligation to register Articles of Association; for a company limited by shares the registration of Articles of Association is an option only. This is because if such a company does not register Articles, Table A by default constitutes the company’s Articles (section 8(2)).

Consistently with what is said above on section 1(1), the obligation to register the company’s constitution (Articles of Association) should fall on the person (or persons) forming the company – ie the founder members. The reference to subscribers to the Memorandum should be replaced by one to the founder members; and instead of being registered with the Memorandum, the constitution should be required to be registered with the new Registration Form.
The description of Articles as “prescribing regulations for the company” is not illuminating to those unfamiliar with the subject, but the fact that the subsection relates to three different types of company makes it difficult, in a subsection relating to all three, to be more specific about the matters to be regulated. The provision should be retained as a description of the function of the constitution.

The distinction between companies limited by shares, where the default provisions of Table A cut in automatically, and other types of company, for which Articles must be registered, should be retained; it might however be clearer to say that companies of all types must register a constitution; but companies limited by shares may state that Table A shall be their constitution; and if they register no constitution they will be deemed to have done so.

Subsection (2). Provides that in the case of an unlimited company with a share capital, the Articles must state the amount of share capital with which the company proposes to be registered. A similar provision relating to a company limited by shares currently requires the information to be included in the Memorandum (section 2(5)(a)). These refer to authorised share capital, which it is proposed to abolish. But details of the initial issued share capital will be required to be given on the new Registration Form (see under section 10(2) below).

Subsection (3). Provides that the Articles must be printed and numbered in consecutive paragraphs, and that the founders’ signatures must be witnessed. It is for consideration whether the third requirement should be retained in primary legislation (on the understanding that it is capable of being modified by a general provision for electronic authentication). The first two should not be. Instead the power to prescribe the form of Articles of Association for different forms of company (see below) should be wide enough to cover such detailed matters of presentation.

Section 8: Tables A, C, D and E

This section gives statutory authority for Table A, the model Articles of a company limited by shares. It also includes a power to prescribe model Articles for each of the other existing types of company. The section complements section 3, the power to prescribe forms of Memorandum (see above).
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Subsection (1). Gives statutory authority for the version of Table A currently in force as having been prescribed by regulations from time to time. The current version is that introduced in 1985 by regulations made under subsection (5) (qv). But there are still a number of companies with the “old” (1948) version, and even older versions.

It is clearly necessary to preserve the statutory basis for all versions of Table A for those companies who have used it, in whole or in part, for their Articles. But Table A has largely been superseded by model Articles used by solicitors and formation agents which, while drawing on Table A, are self contained in form. It is however assumed that the statutory basis of Table A will be preserved for future incorporations, together with the power to alter or replace Table A by regulation.

Subsection (2). Is a default provision. If a company limited by shares is registered with no Articles, the version of Table A in force at the time of registration is deemed to constitute the Articles. If Articles are registered, “insofar as they do not exclude or modify Table A, that Table constitutes the company’s Articles”. This rather awkward formulation is understood to mean that the company has the following options:

- it registers no Articles; then Table A applies;
- it registers Articles consisting of some provisions of Table A but with specified exclusions and amendments; then Table A applies with those exclusions and amendments; and
- it registers self contained Articles, without referring to Table A; then those Articles apply.

It is proposed to retain these three options for the registration of the constitution of a company limited by shares.

Subsection (3). Confirms that where a company has adopted Table A as its Articles, or is deemed to have done so, the relevant version of Table A will remain that in force at the date of registration, even if Table A itself is amended. It will be necessary to retain such a provision.
Subsection (4). Lays down a requirement on the Secretary of State to prescribe by regulations forms of Articles for companies limited by guarantee either without (Table C) or with (Table D) a share capital, and for unlimited companies having a share capital (Table E). This requirement was met by the Companies (Tables A to F) Regulations 1985. The formats in Tables B to F are to be adopted either as they stand, or “as near to that form as circumstances permit”. (NB: Tables B and F constitute respectively Memoranda for private and public companies limited by shares; it is proposed that these should be superseded by information on a new Registration Form – see above on section 3.)

Tables C, D and E contain both Memoranda and Articles. The Memoranda will be superseded by information on the new Registration Form. The provision of this information will be mandatory – not “as near to that form as circumstances admit ”. The model Articles in Tables C and E are variants on Table A with many articles omitted and replaced by much shorter provisions. Table D includes as its Articles Table A unmodified. All of these should be preserved for pre-existing companies. Table D is not needed for new incorporations since there can be no new companies of this type (section 1(4)). It can be repealed. Assuming that Table A is retained as the default constitution for a newly incorporated company limited by shares, (and subject to further examination of the range of corporate vehicles available under the companies legislation) it would seem simplest to retain its variants in Tables C and E. (N.B: There is no default provision analogous to subsection (2) applying to Tables C and E. It is for consideration whether one should be introduced. The “as near ... as circumstances admit ” formula seems unsatisfactory and it is for consideration whether to allow it in future.)

Subsection (5). Provides that regulations under subsection (1) or (4) to amend or replace Table A, C, D or E should be subject to negative resolution. This remains appropriate.
Section 8A: Table G

This section was added by the 1989 Act in response to representations from the employee share ownership lobby, but has never been commenced; despite extensive consultations with the proponents of Table G, agreement has not been reached on the content of model Articles for a “partnership company”. The most recent position is understood to be that a Law Society group examining possible changes in Table A is in contact with the proponents of Table G with a view to meeting their concerns without the need for a separate Table.

It is for consideration whether a separate Table G as the constitution for a partnership company is needed. Statutory authority is not needed for the promoters of such a Table to promulgate it and encourage its use. We doubt whether that is a matter for Government. Substantive changes to the Act for such companies are a separate question, not within the scope of this Document.

Section 9: Alteration of Articles by special resolution

Subsection(1). Provides that a company may alter its Articles by special resolution. This is subject to the provisions of the Act and to conditions in the Memorandum. The first proviso is thought to cover the mandatory requirements in sections 7 and 15 relating to the form and content of the Memorandum and Articles of companies limited by guarantee and unlimited companies, but also makes it clear that alterations which are contrary to other statutory provisions (eg section 459) are not permitted by this provision. This proviso should be retained.

It is for consideration whether it should be more broadly expressed to cover other legal requirements (eg fraud on the minority). The second proviso will fall as it relates to the Memorandum; but it is proposed that a company should be able to include entrenched provisions in its constitution on formation; and that such an entrenched provision could subsequently be added to, or removed from, the constitution by unanimity. (At present the Memorandum may achieve such entrenched.)

Subsection (2). Makes clear that alterations made to Articles – and alterations to alterations! – are as valid as the original Articles. It is unclear why it was thought necessary to state the obvious in this way.
Sections 10-20: Registration and its consequences

Section 10: Documents to be sent to the registrar

Subsection (1). Requires the Memorandum and Articles to be sent to the registrar. This will be replaced by a requirement to send registration particulars in the prescribed form, accompanied by the constitution.

Subsection (1) also nominates the registrar for this purpose as the registrar for England and Wales if the company’s registered office is to be specified as in England and Wales, or in Wales (see above on section 2(1)); and the registrar for Scotland if the registered office is to be in Scotland. A provision to this effect should be retained.

Subsection (2). Requires the Memorandum and Articles to be accompanied by a statement of the first director(s) and secretary(ies). Details of the information to be supplied under this provision are set out in Schedule 1 to the Act.

This subsection should be replaced by a provision setting out the particulars to be included in the new Registration Form. These will comprise:

- the name of the company on first formation (it may change subsequently) (v. section 2(1)(a));

- the jurisdiction of the registered office – England and Wales, Wales alone, or Scotland (v. section 2(1)(b));

- the intended situation (ie address) of the first registered office (v. section 10(6));

- the type of company being registered – private company limited by shares, public company limited by shares, company limited by guarantee without share capital, or unlimited company;

- in the case of a company limited by guarantee, the amount which each member guarantees to contribute to the assets on winding up (v. section 2(4));
in the case of a company limited by shares, or an unlimited company with a share capital (see under section 7(2) above), the amount of share capital initially subscribed and the number of shares into which it is divided (v section 2(5)(a)). The reference in section 2(5)(a) to shares of a fixed amount will only need to be retained to the extent that par values remain. In the case of a public company, the amount of subscribed share capital must be at least the authorised minimum;

- the name of each founder shareholder and the number of shares he takes (v. section 2(5)(c));

- the names and prescribed particulars of the first director(s) and secretary(ies). The particulars in Schedule 1 include, in the case of initial directors, the residential address and details of other directorships. It would be useful to be able to modify the details of the Registration Form without primary legislation, and it is suggested that Schedule 1 be omitted and replaced by a general power to prescribe by regulations the details to be included under each item in the Registration Form; and

- (If unavoidable, and for public companies only) the company’s objects.

**Subsection (3).** Requires the statement of directors and secretary to be signed by the subscribers to the Memorandum and by everyone named in the statement as a director or secretary.

The new Registration Form will need to be signed, for all types of company, by the founder members (formerly “subscribers of the Memorandum”). Those named as director or secretary should also sign. It is for consideration whether the requirement for the signatures to be witnessed, which currently applies to the Memorandum (section 2(6)) should be included here.

It is suggested that, in signing the Registration Form, the directors should, as recommended by the Law Commissions, confirm that they have informed themselves about the legal duties of a director, perhaps by reference to a guidance note to be issued by Companies House.
Subsection (4). Provides that where a Memorandum is delivered by an agent for the subscribers the statement should specify that fact and give the agent’s address. This does not seem an appropriate point for primary legislation. It is suggested that the regulation making power recommended above under subsection (2) should be in sufficiently broad terms to deal with delivery of the Registration Form by an agent.

Subsection (5). Provides that the appointment by the Articles of anyone as a director or secretary should be void if the person is not so named in the statement. This provision should be retained. The requirement to notify the first directors as a separate item on the Registration Form is covered under subsection (2) above. It is wrong that anyone should be put at risk by being named in Articles as a director or secretary without their knowledge. (A person named as director in the constitution, and acting as such, but who has not been named in the statement, will be a de facto director so far as dealings with third parties are concerned.)

Subsection (6). Requires the intended situation of the registered office to be specified in the statement. This is covered under subsection (2) above.

Section 11: Minimum authorised capital (public companies)

This section provides that in the Memorandum of a public company, the amount of share capital stated in the Memorandum (ie authorised share capital) should be not less than the authorised minimum. This provision will fall with the abolition of authorised share capital.

Section 12: Duty of registrar

Subsection (1). Provides that the registrar should not register a company’s Memorandum unless he is satisfied that all requirements of the Act in respect of registration “and of matters precedent and incidental to it” have been complied with.

Subsection (2). Provides that subject to subsection (1) the registrar shall register a Memorandum and Articles delivered to him.
These two subsections might be replaced by a positive requirement on the registrar to register in respect of a new company:

- a completed Registration Form, provided that it includes all particulars required to be included; and

- the company’s constitution.

It is suggested that the requirement on the registrar to be satisfied of “matters precedent and incidental” to registration should disappear, subject to the qualification that the registrar’s duties under the provisions relating to company names are not prejudiced. This apart, the registrar should only have to be satisfied that the Registration Form is complete and that it and the Articles are covered by a declaration of compliance.

**Subsection (3).** This provides for the delivery to the registrar of a statutory declaration, signed by a director or secretary named in the statement submitted, or by a solicitor engaged in the formation of the company, that the requirements in respect of registration have been complied with. The registrar may accept this as sufficient evidence of compliance.

It is proposed to replace the requirement for a statutory declaration with a requirement for a “declaration of compliance” to be delivered with the Registration Form and the Articles submitted. This declaration would confirm the accuracy of the information in the Registration Form, and that the company was formed for a lawful purpose (see under section 1(1)).

There should be a power to prescribe the form of this declaration by regulation. It is envisaged that the declaration need not take the form of a statutory declaration but of a simple statement by a director and secretary as described above. This would dispense with the formalities associated with a statutory declaration, but appropriate penalties would be attracted for knowingly or recklessly making a false declaration. As with the present provision, the registrar would be entitled to accept such a declaration as sufficient evidence of compliance.
Section 13: Effect of registration

Subsection (1). Provides for the registrar, on registration of the company’s Memorandum, to give a certificate of incorporation. In the case of a limited company, this will certify that the company is limited.

The certificate of incorporation should be retained, but should be given on registration of the Registration Form. The certificate of incorporation should include the name of the company and the type of company (private company limited by shares etc). A power to prescribe the form and content of the incorporation certificate would be useful.

Subsection (2). Provides for the incorporation certificate to be signed by the registrar or authenticated by his official seal. Bearing in mind the need for flexibility to accommodate procedures to electronic communication, it would be desirable for a power to prescribe the form and content of the certificate to include a power to prescribe the means of authentication.

Subsection (3). Provides for the subscribers, and subsequent members, to be a body corporate from the date of the incorporation certificate. The reference to founder(s) and later members “being” a body corporate seems out of tune with modern doctrine which regards the company as a body separate from its members. We are inclined to suggest that the language should be modernised to provide that the founder member(s) and subsequent member(s) of the company are to be members of a body corporate with the name set out in the Registration Form. But this is not intended to achieve a substantive change and the drafting will need careful consideration, particularly in relation to the transitional effect on existing companies. Other provisions which raise this are section 1(1), and numerous provisions which refer to “the company in general meeting”. It is for consideration whether the latter should be changed to “the members in general meeting”.

Subsection (4). Provides that the body corporate is, from that point on, able to exercise all the functions of an incorporated company, but with such liability of its members to contribute in a winding up as is provided by this Act and the Insolvency Act. The first point is important, but appears to be no more than that the company’s effective existence in law begins at this point. The second is an assertion that certain incidents of a company’s existence laid down by statute also apply. There may be some advantage in making clear at this point that the members of the
company are liable to contribute only to the extent provided by statute, but on balance it would seem safe, and simpler, to omit this provision.

In the case of a public company a further certificate, under section 117, that the minimum capital requirement is met, is required before the company can begin to exercise its functions (see comments on section 117 below).

**Subsection (5).** Provides that the director(s) and secretary(ies) named on the statement accompanying the Memorandum are deemed to be the first director(s) and secretary(ies). Some means of determining who are the first directors etc is needed, since the company does not yet exist to appoint them in the normal way. The present method will suffice, with the reference being to the directors named as such on the new Registration Form.

**Subsection (6).** Provides that the incorporation certificate of a public company should state that it is a public company. This is dealt with under subsection (1) above. The point could conveniently be covered in regulations prescribing the form of the incorporation certificate.

**Subsection (7).** Provides that a certificate of incorporation is conclusive evidence that the requirements of registration have been complied with; that the “association” is a company authorised to be registered; that the company is duly registered; and, if the certificate states that the company is a public company, then it is a public company.

The substance of this subsection is important since it establishes that, once the incorporation certificate is granted, the existence of the company cannot be challenged on the grounds of a defect in its formation. This disposes of the problems of voidness of a company which occur in some other jurisdictions.

A provision on these lines should be retained, but it could perhaps be simplified by stating that the incorporation certificate is conclusive evidence that the company has been duly registered as a company of the type stated in the certificate, and is capable of exercising all the functions of such a company. This would arguably make the first part of subsection (4) superfluous. The reference to “association” should be dropped.
Section 117: Public company share capital requirements

This section provides a mechanism for creating a public company from scratch, as distinct from the reregistration of a private company. The main point of the section is to ensure that companies formed as public companies cannot commence business without the necessary minimum share capital (see section 118). In CA1985, the section appears under “General Provisions About Share Capital”, but apart from subsection (4) the matters it deals with more logically fall to be considered under company registration.

Subsection (1). Provides that a company formed as a public company may not do business or exercise borrowing powers unless it has either received a “trading certificate” issued by the registrar, in addition to the certificate of incorporation issued under section 13, or is reregistered as a private company. (Where a public company is created by reregistration of a private company, a single certificate confirms both the change of status and entitlement to do business as a public company – v. sections 43-47.)

Subsection (2). Requires the registrar to issue a trading certificate if, on application to him in prescribed form, he is satisfied that the allotted share capital is not less than the authorised minimum (see section 118) and that a statutory declaration complying with subsection (3) is delivered to him.

Subsection (3). Lays down that the statutory declaration must be in the prescribed form and signed by a director or secretary of the company. It must:

- state that the allotted share capital is not less than the prescribed minimum;

- specify the amount paid up on the allotted share capital (implementing Article 3(g) of the Second Directive);

- specify the amount of the company’s preliminary expenses and the persons to whom they have been paid or are payable (implementing Article 3(j) of the Second Directive, but that paragraph does not require the recipients to be disclosed); and
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- specify any benefit paid or given, or intended to be paid or given, to any promoter, and the consideration for such benefit (implementing Article 3(k) of the Second Directive).

**Subsection (4).** Provides that while shares issued in pursuance of an employees’ share scheme do not have to be paid up (see under section 101(2) above), such shares cannot count towards the authorised minimum unless they are paid up to the extent of 25% of nominal value and 100% of any premium.

**Subsection (5).** States that the registrar may accept the statutory declaration as sufficient evidence of the matters contained in it (cf. section 12(3), on the statutory declaration to be delivered with the Memorandum).

**Subsection (6).** States that the “trading certificate” is conclusive evidence of the company’s entitlement to do business and exercise borrowing powers (cf. section 13(7) on the conclusive nature of the certificate of incorporation).

**Subsection (7).** Provides for fines on the company or any officer if the company does business or exercises borrowing powers in contravention of this section.

**Subsection (8).** Preserves the validity of transactions entered into in contravention of this section, but renders the directors (rather than the company) liable to indemnify the other party for any loss resulting from the company’s failure to carry out its obligations under the transaction within 21 days.

It is suggested that the procedure for forming companies as public companies should be simplified as follows:

- by combining the separate incorporation and trading certificates in a single incorporation certificate which would also serve as an authorisation to do business;

- by expanding for public companies the basic version of the suggested new Registration Form (see under section 10 above) so as to include the details in section 117(3)(b)-(d). ((a) is covered already); and
- by ensuring that the expanded Registration Form is covered by the suggested new “declaration of compliance” which would replace the statutory declaration now required in support of Memoranda submitted for registration (see under section 12(3) above). This could, inter alia, confirm that the company would, immediately on incorporation, receive the payment up of the minimum capital. (Such entitlement could be effectively achieved by suitable contingent provision, eg by conferring the assets on a trustee on trust for the company on its incorporation.)

If this were done, the consequences for the present section 117 would be as follows:

- subsections (1) and (2) would fall with the disappearance of the separate trading and incorporation certificates and of the statutory declaration;

- the contents of subsection (3)(b)-(d) would be added to the version of the new Registration Form for companies incorporated as public companies;

- subsection (4) would be retained in the part of the legislation dealing with share capital, as a qualification to the definition of the authorised minimum (but it may be noted here that the provision will need consideration in the context of no par value shares);

- the content of subsections (5) and (6) would be covered in the parallel provisions on registration; and

- subsections (7) and (8) would fall. The fact that there would no longer be any gap in the case of companies formed as public companies between incorporation and authority to do business would mean that the situation contemplated in these subsections could not arise.

Section 14: Effect of Memorandum and Articles

Subsection (1). Provides that the Memorandum and Articles of a company, once registered, bind the company and its members as if they had been signed and sealed by each member and contained covenants on the part of each member to observe all the provisions of the Memorandum and Articles.
The effect of this provision is to confer contractual force on the Articles insofar as they apply to the members as members, creating a contract between each member and the company (see Hickman v Kent etc [1915] 1 Ch 708). Although the approach seems correct of regarding the constitution as, in essence, a contract between the company and its members (and between its members inter se) the current version of section 14 has given rise to complex and difficult case law, which may be regarded as in need of codification and simplification. The New Zealand legislation of 1993 provides that:

“Subject to this Act, the constitution of a company is binding as between:

(a) the company and each shareholder; and

(b) each shareholder – in accordance with its terms.”

It is suggested that section 14(1) might be reformulated on similar lines; it is for consideration whether it should be made clear that the obligations created are contractual. We can see no case for changing the legal character of the obligation imposed on the members by the Articles. However, the antique pre-Judicature Act language of the section might be updated by providing that as between members and the company the Articles bind the members as they would had they been incorporated into a contract between each member and the company. It is for proposed that the law should be changed to provide that the company is also bound and that members are bound inter se. It is also for consideration whether the relationships created by the constitution should extend to the directors and officers of the company.

Subsection (2). Provides that money payable by a member to the company under the Memorandum or Articles is a debt. In England and Wales it is a speciality debt. The effect appears to be to extend the limitation period to 12 years in England and Wales. In Scotland it is not clear that the provision adds anything to subsection (1). It is for consideration whether this provision has any remaining value.
Section 15: Memorandum and Articles of a company limited by guarantee

The purpose of this section is to prevent the creation de facto of a company limited by guarantee with a share capital (prohibited from 1980 under section 1(4) of CA1985) by finessing the constitution of a company limited by guarantee without a share capital.

Subsection (1). Provides that any provision in the Memorandum or Articles of a company limited by shares without a share capital, or any resolution of the company, purporting to give any person a right to participate in the divisible profits of the company otherwise than as a member, is void.

Subsection (2). Provides that for the purposes of provisions of the Act relating to the Memorandum of a company limited by guarantee, and for those of section 1(4) and this section, any provision in the Memorandum or Articles, or any resolution, purporting to divide the undertaking of the company into shares or interests is to be treated as a provision for share capital.

It is proposed to retain the substance of this provision, referring to the constitution.

Section 16: Effect of alteration on company’s members

Subsection (1). Provides that a member is not bound by changes to the Memorandum or Articles, made after he becomes a member which oblige him to take more shares or pay money to the company.

Subsection (2). Makes clear that subsection (1) overrides anything in the Memorandum and Articles, but does not apply where the member agrees to be bound by the alteration.

It is proposed to retain the substance of this section as it applies to the company’s constitution. It might cover the imposition of any liability on a member without his express agreement. The requirement for writing seems arguably excessive.
Section 17: Conditions in Memorandum which could have been in Articles

This section modifies the provisions in sections 4-6 for the alteration of Memoranda, for those provisions which could legally equally well have been in the Articles, enabling them to be altered by special resolution, but with special minority protection.

With the disappearance of Memoranda, the provisions in this section will have no application for newly incorporated companies. It is for consideration whether, for pre-existing companies, the right to apply to the court for the alteration to be cancelled should be discontinued, and that such alterations should be able to be made by special resolution, as they could be if the same provision appeared in the Articles. Consideration will need to be given to the question whether existing provision for entrenchment in company Memoranda should continue in their present form (see section 17(2)(b)). This could if desired be balanced by provision for companies to entrench provisions in their constitution (see under section 9(1) above).

Section 18: Amendments of Memorandum or Articles to be registered

Subsection (1). Addresses the case where a change is made in a company’s Memorandum or Articles by a statutory provision (ie not by special resolution of the company). The company must send to the registrar a copy of the provision concerned within 15 days of its entry into force.

Subsection (2). Requires the company, where it is required (by this section or otherwise) to send to the registrar a document evidencing a change in the Memorandum or Articles, also to send a printed copy of the Memorandum or Articles as amended.

Subsection (3). Provides for fines for failure to comply with this section.

Amendments to the Articles made by statute or statutory instrument should be delivered to the registrar in the prescribed form. The requirement to send a copy of the Articles as amended should also be retained (though the requirement for a printed copy should be dropped to facilitate electronic filing).
The requirement, where Articles are amended by statute or statutory instrument, to file a copy of the instrument concerned, seems unduly onerous. It should be enough for the company, when filing the amendment, to identify the instrument making the alteration.

The question of penalties for procedural defaults will be considered separately.

Section 19: Copies of Memorandum and Articles to be given to members

Subsection (1). Requires a company to send to any member on request a copy of the Memorandum and Articles, and of any Act of Parliament amending the Memorandum.

A charge not exceeding 5p may be made for the Memorandum and Articles. A charge equal to the purchase price may be made for an Act of Parliament.

Subsection (2). Provides for fines for failure to comply with this section.

The obligation to send a copy of the Articles and (in the case of a pre-existing company) the Memorandum to a member on request should be retained. The charge now permitted is derisory. It would be simplest to provide for copies to be sent free of charge.

The obligation to send an Act of Parliament does not extend to subordinate legislation and applies only to the Memorandum not the Articles. It is suggested that this be dropped. Provision should be made that in such a case the Act or instrument concerned is to be identified in the text of the amended Articles. The question of penalties for procedural defaults will be considered separately.

Section 20: Issued copy of a Memorandum to embody alterations

Subsection (1). Provides that where an alteration is made to a company’s Memorandum, every copy issued subsequently must reflect the alteration.

Subsection (2). Provides for fines for failure to comply with this section.

It is not clear why this provision was thought necessary at all, since the issue of an out of date Memorandum can hardly comply with an obligation to issue the Memorandum.
It is suggested that this provision should be dropped as unnecessary. (The alternative would be a general provision that references to publicity for the constitution are to the up to date version.)

**Section 21**

This has been repealed (SI 94/115).

**Sections 22-24: A company’s membership**

**Section 22: Definition of “member”**

The purpose of this section is to provide a definition of a member of the company which covers both the initial formation of the company and its subsequent life.

**Subsection (1).** Provides that the subscribers to the company’s Memorandum are deemed to have agreed to become members of the company and on its registration shall be entered on its register of members.

This answers the question “who are the members of the company?” at its formative stage, and before the creation of the register of members. The Memorandum as such will disappear, and it is suggested that the term “subscriber” should be replaced by “founder member” (see on section 10(3) above). It is therefore suggested that the new definition of “member” should refer to the founder member or members who have signed the Registration Form (see on section 10(3) above); the requirement that, on registration, the founder members should be entered on the register of members should be maintained provisionally, pending examination in the Review of the statutory provisions relating to the records to be maintained by the company.

**Subsection (2).** Provides that every other person who agrees to become a member, and whose name is entered on the register of members, is a member of the company. (This provision relates not to the formation of the company but to the membership of the company after formation. The Treasury has recently proposed that, in relation to uncertificated securities, it should be the records maintained by the Operator which confer legal title and company membership. This provision will also be considered by the Review in the context of the statutory provisions relating to the
records to be maintained by the company. Consideration of the rights of beneficial owners of shares may also touch on this provision.)

**Section 23: Membership of holding company**

This section lays down the principle that a subsidiary cannot be a member of its own holding company, and sets out a number of exceptions to the principle. It has nothing to do with company formation and will be considered elsewhere in the Review.

**Section 24: Minimum membership for carrying on business**

This section deals with the situation where a company, other than a lawful single member company, has a membership which falls below the present minimum of two, by imposing personal liability on the (one) remaining member. Since it is proposed to abolish this minimum, and permit single member companies of all types (see on section 1(1) above), this provision in its present form can be repealed, leaving the general law to apply to cases where a company has no members as it does now to single member companies which lose their one member.

**Sections 35-35B: A company’s capacity (with sections 322A and 711A)**

**Section 35: A company’s capacity not limited by its Memorandum**

**Subsection (1).** Provides that the validity of an act done by the company shall not be called into question by anything in the Memorandum. This should be replaced by a provision that a company shall have unlimited capacity. This is to be so, in the case of a company with objects, regardless of anything in the objects (ie whether the objects are set out in the Memorandum of a pre-existing company or are stated on the Registration Form of a new public company). The effect of this will be that objects clauses will be without effect externally, in limiting the scope of the company’s dealings with third parties, both as a matter of the capacity of the company and as a matter of limitation of the authority of any agent or officer to bind the company. However, it is proposed that if objects clauses are retained it should be possible for officers and agents to be restrained internally from exceeding them without prejudice to the rights of third parties. This provision will subsume subsection (2).
Subsection (3). Provides that it remains the duty of directors to observe limitations on their powers resulting from the Memorandum, and sets out the special resolution procedure for ratifying acts beyond those powers. It is suggested that an ordinary resolution should suffice even for acts beyond the objects of the company, where the company chooses to retain an objects clause.

Subsection (4). Provides that this section is subject to relevant provisions of the Charities Act and to section 322A on the invalidity of certain transactions to which directors or their associates are parties. It is proposed to retain this provision.

Section 35A: Powers of the directors to bind the company

Subsection (1). Provides that in favour of a person dealing with the company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company’s constitution.

“Dealing with”, “good faith” and “any limitation under the company’s constitution” are elaborated in the two following subsections. (The qualification that only a third party acting in good faith is protected is not at first sight covered by the relevant provision of the First Directive (Article 9.2). But Member States have the option under Article 9.1 of introducing such a qualification relating to acts beyond the company’s capacity. It was decided in 1972 not to take advantage of the qualification in Article 9.1, but records indicate that the Commission advised at that time that a similar qualification should be understood to apply also to Article 9.2, dealing with acts beyond the powers of the directors.)

The substance of this provision, protecting “innocent” third parties where directors and others act beyond their powers, should be retained. It should be noted that the subsection refers to the board of directors, and to others authorised by the board, to bind the company. This wording was chosen in the 1989 Act in order to establish the board as the ultimate source of all such authority in the company. The intention was that this provision, read together with the requirement in section 289 to register particulars of directors, would achieve compliance with the obligation in Article 2.1(d)(i) of the First Directive to ensure disclosure of details of the appointment etc of
persons authorised, individually or as a body, to represent the company in dealings with third parties. It is important that the wording here should cover both actual and ostensible authority.

Subsection (2). Contains three clarifications of subsection (1). Paragraph (a) states that a person deals with a company if he is a party to any transaction or other act to which the company is a party. This is widely drawn and covers not only commercial transactions with an element of reciprocity, but the recipients of gifts etc. This seems right. Paragraph (b) provides that a person shall not be regarded as acting in bad faith by reason only of his knowing that an act is beyond the powers of the directors under the company’s constitution. This is meant to cover for example the case where the “person” is an organisation, and the knowledge exists in a different part of the organisation from that deciding on the transaction; and the case where there was knowledge in the past which has not survived in the organisational memory. But it should exclude all cases where there is an element of collusion between a director and a third party, to the disadvantage of the shareholders. Paragraph (c) provides that where the question of bad faith is raised, the onus of proof should be on the person alleging bad faith. This seems right.

Subject to consultation, it is suggested that provisions on the above lines should be retained.

Subsection (3). Clarifies what is meant by a limitations under the company’s constitution. These include (in addition to limitations in the Memorandum or Articles) limitations deriving:

a) from a resolution of the company in general meeting or a meeting of a class of shareholders; and

b) from an agreement between the members of the company or of any class of members.

a) is clearly right, subject to what may be decided about company meetings. b) refers to the unanimous shareholder agreements which are recognised elsewhere in the Act (eg section 380(4)(b)) as having equivalent effect to resolutions.

Subsection (4). Preserves the internal force of limitations on the powers of directors by asserting the right of an (individual) member to bring proceedings to restrain the doing of an act beyond the powers of the directors; but preserves the position of third parties by excluding proceedings
where the act is to be done in fulfilment of an earlier obligation. Both parts of this provision should be retained.

**Subsection (5).** Provides that where directors, or any other person, incur liability by reason of the directors exceeding their powers, that liability is unaffected. In the case of directors, that liability may be incurred either under statute or common law. A third party may also incur liability, eg for knowingly assisting in a breach of trust by a director, even though the transaction is protected.

**Subsection (6).** Provides that this section is subject to relevant provisions of the Charities Act and to section 322A on the invalidity of certain transactions to which directors or their associates are parties. The effect in the case of charitable companies is to restrict the protection extended to third parties and to give higher priority to protecting the beneficiaries of the charity against the results of malpractice by directors (see above under section 35(4)). It is not intended that this policy should change. In such cases the transaction may be voidable at the instance of the company, and the director or associate is liable to account for any resulting gain or indemnify the company against a resulting loss. We propose to retain the section 322A exception.

**Section 35B: No duty to enquire as to capacity of company or authority of directors**

This section provides that a party to a transaction with a company is not bound to enquire as to whether it is permitted by the company’s Memorandum or as to any limitation on the powers of the board of directors to bind the company or authorise others to do so. This makes clear that failure to make enquiries is not to constitute bad faith. The first part of the provision falls as third parties need no longer be concerned with the Memorandum. But the second part should be retained to make it clear that absence of enquiry does not amount to bad faith for section 35A and that there is no constructive notice as to the authority of a company’s agents – see also on section 711A below.
Section 322A: Invalidity of certain transactions involving directors etc

This section modifies the protection given to third parties by section 35A where the third party is himself a director or a person or company associated with a director. (The discussion of the section here is provisional, pending the detailed examination of Part X. The Law Commissions have taken the view, in the light of the response to consultation on the point, that they are not aware of deficiencies in this section.)

Subsection (1). Establishes the scope of the modification provided by the section. It applies where a company enters into a transaction to which the (other) parties include either a director of the company or its holding company, or a person connected with the director or a company with which he is associated; and where the board exceed any limitation on their powers under the constitution.

Subsection (2). Provides that a transaction of the kind described in subsection (1) is voidable at the instance of the company – thus the company may choose whether to declare the transaction void or allow it to stand. If the company takes no action, the transaction remains valid. In the absence of other provision, the transaction is to be declared void by ordinary resolution. The circumstances in which the company can no longer declare the transaction void are set out in subsection (5) – see below. There seems no reason to change the substance of this provision.

Subsection (3). Provides the sanction against those involved in the transaction. These include both a director (but not a subordinate officer) who has authorised the transaction on the company’s side; and the non-independent third party as described in subsection (1). Whether or not the company has declared the transaction void, the above parties are liable a) to account to the company for any gain made directly or indirectly from the transaction and b) to indemnify the company for any loss or damage resulting from the transaction. These sanctions seem appropriate.

Subsection (4). Provides that the section should not exclude any other enactment or rule of law by virtue of which the transaction might be challenged or liability arise. This may be an unnecessary statement of the obvious.
Changes needed to the Companies Act 1985 to Implement the Recommendations on Company Formation

**Subsection (5).** Sets out the circumstances where a transaction is no longer voidable under subsection (2). These are:

a) where restitution of any money or other asset the subject of the transaction is no longer possible. This makes obvious sense;

b) where the company is indemnified for any loss or damage resulting from the transaction. So does this. (The relationship of this to subsection (3)(b) is a little obscure; the position seems to be that if the transaction is declared void first, the parties are liable to indemnify the company for loss or damage up to that point; but that if the indemnity has already been given, it makes no sense then to declare the agreement void);

c) where rights acquired bona fide, for value and without notice of the directors’ exceeding their powers, by a person not party to the transaction, would be affected by the avoidance. This provision protects the position of innocent third parties who receive property subsequently as a result of the transaction, but only if they have acquired the property for value. It is for consideration whether the protection for innocent third parties should be restricted in this way; and

d) where the transaction is ratified by the company. Ratification may be by ordinary resolution, or (where required eg by section 35(3)) by special resolution, or by unanimous consent of the shareholders.

**Subsection (6).** Provides that a person other than a director of the company is excused liability under subsection (3) if he shows that at the time the transaction was entered into he did not know that the directors were exceeding their powers. The persons referred to here seem to include a director of a holding company; a person connected with a director of the company; and a company with whom the company is associated. It is for consideration whether these non-independent persons should have their interests protected vis a vis the company only in cases where they did not actually know that the directors were exceeding their powers. It is arguable that they should only be excused when not at fault.
**Subsection (7).** Deals with the case where some of the counterparties to the transaction are in the categories described in subsection (1) and others are not. It makes clear that in principle the latter benefit from the protection conferred by section 35A(1). It then deals with the consequences of the fact that the transaction may also be voidable. The “independent” third party may apply to the court for an order affirming, severing or setting aside the transaction. There is no obvious alternative way of dealing with this situation.

**Subsection (8).** Makes clear that a transaction in this section means any act (thus including gifts etc); and replicates the amplification in section 35A(3) of what is meant by “limitations under the company’s constitution”.

**Section 711A: Exclusion of deemed notice**

This section has a much wider application than the documents registered when a company is formed, but it may be convenient to discuss it here first and return to it as necessary later in the Review.

**Subsection (1).** Provides that a person shall not be taken to have notice of a matter merely because it is disclosed in a document kept by the registrar or made available for inspection by the company. The substance of this is important and should be retained. The reference to a document may be obsolete in view of developments in electronic communication. Indeed, subsection (3) states that a “document” includes any material which contains information.

**Subsection (2).** States that subsection (1) does not affect the question whether a person is affected by reason of failure to make such enquiries as ought reasonably to be made. This qualifies the outright abolition of deemed notice to an uncertain extent; it also sits oddly with section 35B (see above). It is for consideration whether this provision should be dropped.

**Subsection (3).** Is dealt with above under subsection (1).
Subsection (4). Seeks to retain deemed notice for the registration of certain charges. (The reference to section 416 of CA1985 is to the “new” section 416 in the revised Part XII of the Act which was to have been introduced by the 1989 Act. The fact that the new Part XII has not been commenced has meant that section 711A could not be commenced either.) The case for this limited retention of deemed notice will be considered later, when the Review examines the registration of company charges.
Sections 97-98: Commissions and discounts

The purpose of these sections is to prevent, subject to limited exceptions, the erosion of share capital through the giving of commissions and discounts on the issue of shares. As regards public companies, section 97 also now implements the Member State option, in Article 8.2 of the Second Directive, to exempt discounts paid to professionals who undertake to place shares with third parties from the prohibition in Article 8.1, on the issue of shares at a discount to nominal value (or accountable par). The exemption is expressed in section 97 in terms of a “commission” rather than a “discount” (although that distinction will only be relevant in the case where the discount is a discount to nominal value, as opposed to premium).

Section 97: Power of company to pay commissions

The exception to the prohibition on commissions is presented before the prohibition itself (see section 98).

Subsection (1). States that it is lawful for a person to pay a commission to any person in consideration for his subscribing or agreeing to subscribe, or procuring or agreeing to procure subscriptions, for any shares in the company. It thus covers payment to underwriters (subscribing or agreeing to subscribe) and to firms who place shares with third parties (procuring or agreeing to procure). Both kinds of arrangement are covered by the words of Article 8.2 – “those who undertake to place shares in the course of their profession”.

The freedom to pay commission is subject to the conditions in subsection (2), and to disclosure requirements. The latter are now set out for unlisted securities in paragraph 23 of Schedule 1 to the Public Offers of Securities (POS) Regulations 1995; and for listed securities in paragraph 6.B.15 of the Listing Rules.
Subsection (2). Provides that the commission must not exceed 10% of the issue price or such lower rate as is set by the Articles.

Section 98: Apart from section 97, commissions and discounts barred

Subsection (1). Provides that, except as provided in section 97, no company shall apply any of its shares or capital money in payment of commission of the kind described in section 97(1). “Capital money” here refers to consideration received for shares issued, including share premium. It seems to follow from this provision that conditions laid down in section 97, for the payment of a commission, apply only to payments out of capital (as opposed to a payment out of profits or non-capital reserves).

Subsection (2). Is an anti-avoidance provision. It catches the use of shares or capital money to inflate the contract price for goods supplied to, or work done for, the company.

Subsection (3). Preserves the right of the company to pay “such brokerage as has previously been lawful”. The scope of this subsection in modern commerce is obscure. It is not clear what if anything this adds to the exemption provided by section 97, and it is now proposed to drop it.

Subsection (4). Extends the company’s right to pay commissions under section 97 to several categories of person acting on the company’s behalf.

It is proposed to retain the substance of these two sections for public companies apart possibly from section 98(3) – see above. It is suggested that the provisions of these two sections should not be retained for private companies. (They will have no meaning for private companies if nominal value is abolished – see below on section 99.)
Sections 99-107: Amount to be paid for shares: the means of payment

Section 99

This section contains the rules on payment for shares on allotment.

Subsection (1). States the general rule that shares must be paid up in money or money’s worth, (including goodwill and know-how). In the case of public companies, it implements the first sentence of Article 7 of the Second Directive. In the case of private companies; this provision is believed to reflect the position under common law. There is no proposal to abandon this rule. (Exceptions are set out in later provisions.) But for private companies, the rule would need to be reformulated as a rule that the consideration for the shares allotted, less any commission or discount, must be paid up in money or money’s worth.

Subsection (2). Provides that a public company may not accept in payment up for shares an undertaking that a person will undertake services. It implements the second sentence of Article 7 of the Second Directive. The added provision that undertakings by third parties are covered by the prohibition is not in Article 7, but is probably implicit in it. It is not proposed to extend the restriction in this subsection to private companies.

Subsection (3). Provides a sanction for breach of subsection (2). The principle that the holder of the shares at the time of the allotment should pay, in money and with interest at the “appropriate rate”, the amount treated as paid up by the undertaking should stand. (The position of subsequent holders is covered in section 112.) The reference to nominal value and premium are inappropriate to an NPV environment. (It would be necessary to reformulate for an NPV environment the rule on the minimum proportion of the value of a share to be paid up, but this is dealt with under section 101 below.) But here it would seem to be enough to provide simply for an obligation to pay in money and with interest an amount equal to that treated as paid by the undertaking; a provision in those terms seems to fit equally well a par value and an NPV environment. The “appropriate rate” of interest is defined in section 107. It is proposed to replace “the appropriate” rate of interest with a reference to a reasonable commercial rate of interest or some similar wording (see below under section 107). It is also proposed to make clear that if a public
company accepts an undertaking in payment up for shares, in contravention of subsection (3), the allotment nevertheless stands. (cf. section 101(3)).

Subsection (4). Preserves the right of companies, public and private, to issue bonus shares, and to pay up “with sums available for the purpose” (ie from distributable reserves, or from capital reserves in the case of bonus shares) amounts unpaid on any of its shares whether by way of nominal value or premium. The substance of these rights should be preserved. But the parenthesis referring to nominal value and premium would be inappropriate for an NPV environment.

Subsection (5). Makes clear that the reference to a holder of shares includes a person with an unconditional right to be included in a company’s share register or to have a transfer executed in his favour. A provision to this effect should be retained. (The terms in which it is expressed may need to be reviewed in the light of work elsewhere in the Review on the definition of a shareholder and on company registers.)

Section 100

This section prohibits the allotment of shares at discount to nominal value. For public companies, it implements Article 8.1 of the Second Directive (though it has been part of our law since 1900), which provides that “shares may not be issued at a price lower than their nominal value or .... accountable par”; the concept of “accountable par” is relevant only to no-par value shares, in the restricted form in which they are permitted by the Second Directive. (The exception in Article 8.2 for commissions to those placing shares is covered in sections 97 and 98.) The extension to private companies is believed to reflect the common law position.

This provision appears to have two objectives. The first is to ensure that the liabilities represented by the increase in nominal capital are (at least) matched by the assets represented by the consideration received or due; the second – subject to the permitted discounts and commission – is to ensure against discrimination between shareholders in the price at which shares in a given issue are allotted. There is no equivalent provision for share premium. Because (we believe) share premiums are by definition equal to the difference in value of the consideration received and the nominal value, there is no need for such a provision in relation to
premiums to address the first objective in that context. But that would not prevent shares being issued at different premiums. For public companies, on the assumption that par values must be retained, it is proposed to retain the substance of the present provision. For private companies, and for public companies if par values need not be retained, there is a choice. One option would be to replicate the present position as closely as possible by providing that (subject to the exceptions for commissions and discounts) all of the shares comprised in an issue of shares must be issued at a single price; this would have the effect of applying both objectives to the whole of the consideration received. The alternative would be a looser provision that the consideration received or due for an issue of shares must equal the amount credited to the combined share capital account (net of any commission or discount), leaving open the possibility that not all the shares comprised in the issue would be issued at a single price, thus achieving only the first objective. This rule would really be merely an aspect of the definition of a no par value share. We prefer the latter approach, leaving the issue of equality of treatment of shareholders (required for public companies by Article 42 of the Second Directive) to the general law.

Subsection (2). Provides a sanction for the breach of the prohibition. The allottee is obliged to pay up the amount of the discount, plus interest at the “appropriate rate”. It is proposed to retain this provision (apart from the reference to the “appropriate rate” – see on section 99(3) above) for public companies if nominal values are retained; and to make clear that if a public company accepts an undertaking in payment up for shares, in contravention of this section, the allotment nevertheless stands (cf. section 101(3)).

So far as the equivalent rule proposed for NPV shares is concerned, a decision by the company to represent no par value shares in stated capital account at more than the consideration received is not a matter of which the allottee of the relevant shares is likely necessarily to be aware. It is for consideration whether any additional sanction is required in this context beyond the requirements relating to the proper preparation and maintenance of the company’s accounts and accounting records and the law as it relates to participation in breach of duty by company directors, etc. On balance we believe that no further provision is justified.
Section 101

This section applies to public companies only. It implements the requirement in Articles 9 (for shares issued on incorporation) and 26 (for shares issued on an increase of capital) of the Second Directive that shares must be paid up to at least 25% of the nominal value (or accountable par, in the case of the limited form of no par value shares permitted by the Directive). There is no comparable requirement for private companies.

Subsection (1). Enacts the basic rule, and adds that the whole of any share premium must also be paid up. This is a requirement of Article 26 of the Second Directive but not of Article 9. This requirement should remain for public companies if par values must be retained. If NPV becomes available for public companies, it will be necessary to reformulate a rule on minimum payment up.

Subsection (2). Exempts from the payment up requirement shares issued in pursuance of an employees’ share scheme. This takes advantage of the Member State option in Article 41 of the Second Directive. It is proposed to retain this exemption.

Subsection (3). Provides that if shares are issued in contravention of the rule on payment up, they are to be treated as if 25% of the nominal value, plus the whole of the share premium, had been paid up. The effect is to ensure that the shareholder has a right to be registered as a shareholder in the absence of payment up, and has the same rights eg to dividends as would apply in the case of properly paid-up shares.

Subsection (4). Provides that the allottee in such circumstances is liable to pay up the minimum amount which should have been received, plus interest at the “appropriate rate”. It is proposed to retain this provision (apart from the reference to the “appropriate rate” – see on section 99(3) above).

Subsection (5). Exempts the allotment of bonus shares from subsections (3) and (4), unless they have been allotted in contravention of subsection (1) – ie they have not been paid up by the company. This is in line with the terms of Article 9 of the Second Directive, which refers to shares “issued for a consideration” – ie excluding bonus shares. If the allottee of bonus shares knew, or ought to have known, that the bonus shares had not been paid up, he has a right to be registered as a shareholder but must pay up the shares himself. It is proposed to retain this.
position if the allottee did not know that the bonus shares had not been paid up appears obscure. As an allottee, the shareholder presumably retains the right to be registered as such, but has neither such benefits as are conferred by subsection (3) nor the burdens imposed by subsection (4). It is proposed to clarify the law by providing that in these circumstances the allotment is void.

Section 102

This section applies to public companies only. It implements Article 9.2 of the Second Directive, which provides that where shares are issued for a consideration other than cash at the time the company is incorporated or is authorised to commence business, the consideration must be transferred in full within five years; and the similar requirement in Article 27 where shares are issued for a consideration other than in cash in the course of an increase in subscribed capital. As noted below under section 106, payment in cash is given a broad definition in the Act, and at present includes an undertaking to pay cash at a future date.

Subsection (1). Implements the basic rule.

Subsection (2). Provides as a sanction for breach of the rule that the allottee is liable to pay the whole of the nominal value and premium, plus interest. This should be retained – but if NPV becomes available for public companies, this will need to be reformulated in terms of the whole amount payable.

Subsections (3)-(7). Add precision to subsection (1). They cover the case where it is a variation of a contract which breaches the rule (3); where the original contract was signed when the company was a private company (4) (NB: The case where a contract concluded by a private company did not comply with the rule in subsection (1), and the private company subsequently reregistered as public, but the contract was not varied, is dealt with in the reregistration provisions – section 45(4)); where the contract was compliant with the rule but the undertaking was not performed within the five years (5) and (6); and where the undertaking was contained not in the contract for allotment but in an ancillary contract relating to payment (7).
It is proposed to retain the substance of this section. But subsections (3) – (7) anticipate possible variations on the most straightforward case, arising either in the ordinary course of events or as a result of deliberate avoidance. It is for consideration whether, if those subsections did not exist, the courts could be relied on to reach conclusions on the matters covered in them consistent with the purpose of subsection (1) and Article 9.2; and whether there are means, other than detailed statutory provisions of this kind, which could ensure that they did.

Section 103

This section provides for the valuation of non-cash consideration for the allotment of shares in a public company. It implements the requirements in Article 10 of the Second Directive, (where shares are issued when a company is incorporated or commences business) and in Article 27 (where the shares are issued in the course of an increase in capital); and sets out several exceptions to the valuation requirement. The details of the valuation procedure are set out in sections 108ff (qv).

Subsection (1). Sets out the requirement for independent valuation where shares in a public company are allocated for non-cash consideration. It is not limited to the case where shares are issued when a company is incorporated or commences business (cf. s102(1)). It also provides that allotment must take place within six months of receipt of the valuation report; and that a copy of the report must be sent to the proposed allottee. Neither of these requirements is in the Directive, but both seem sensible.

Subsection (2). Makes an exception to the valuation requirement where the payment up (or part of it) is by the company in the form of the application of reserves or of the profit and loss account. Arguably, payment up from reserves etc is not “for consideration” for the purposes of Articles 10 and 27.
**Subsections (3) and (4).** Read with subsection (7)(a) make an exception from the valuation requirement for shares issued as part of a share exchange under a company’s compromise with its creditors or members (section 425), provided that the shares issued are available on equal terms to the shareholders of the other company; and for the issue of shares to a liquidator in return for the assets of a company being wound up (section 110 of the Insolvency Act).

**Subsection (5).** Makes an exemption from the valuation requirement for shares allotted in connection with a merger with another company by share exchange. This takes advantage of the Member State option in Article 27.3 of the Second Directive.

**Subsection (6).** Provides the necessary sanction for breach of subsection (1). As with section 102, the allottee is liable to pay the whole of the nominal value and premium, plus interest at the “appropriate rate”. Here too, if NPV becomes available, this will need to be reformulated in terms of the whole amount payable.

**Subsection (7).** Defines an arrangement for the purpose of subsection (3) and makes clear that the company in subsections (3) and (5) other than that allotting shares need not be a public company.

Given the basic requirement in Article 10, all of the above provisions seem to be good policy. But it is for consideration first, whether by legislating expressly to ensure a purposive interpretation of Article 10 and subsection (1), the need for the detail in subsections (2), (3), (4), (5) and (7) could be avoided altogether; and second, whether the effect of those sections could be achieved by shorter and plain language statements of the purpose of each provision, placing more reliance on the discretion of the courts to deal with hard cases and evasions.

**Section 104**

This section implements Article 11 of the Second Directive, which imposes a valuation requirement where a public company, within two years of incorporation or commencement of business, acquires from a signatory of the document of incorporation an asset for a consideration of at least one tenth of the subscribed capital. This is aimed at the purchase by the company of property from the promoters at an inflated price. It should be noted that the statutory provision, like Article 11, refers to the subscribers, who may or may not be the true promoters.
Subsection (1). Prohibits, for a public company, such an acquisition unless the conditions in the following subsections are fulfilled.

Subsection (2). Provides for the two year duration of the prohibition.

Subsection (3). Extends the rule, mutatis mutandis, to the case of a private company re-registering as a public company.

Subsection (4). Sets out the conditions relating to the valuation. There must have been an independent valuation under section 109 of the consideration for the asset; the valuation report must have been made to the company no more than six months before the agreement to the transaction; the agreement must have been approved by an ordinary resolution of the shareholders (a requirement of Article 11); copies of the resolution must have been circulated.

Subsection (5). Adds two elements of precision:

- the case is covered where the asset is transferred to a third party but an advantage accrues to the company; and
- the requirement for a valuation report is without prejudice to any requirement for a valuation report required for the purposes of section 103.

Subsection (6). Exempts agreements in the following circumstances:

- where it is part of the company’s ordinary business to acquire assets of the kind in question. (This exemption is provided in Article 11.2); and
- where the agreement is entered into under the supervision of the court for the purpose of transferring an asset from one company to another.

Given Article 11, it is intended to retain the provisions of this section in substance.
Section 105

This provides the sanction for breach of section 104.

Subsection (1). Provides that the breaches covered are:

- failure of the person entering into an agreement with the company to receive a valuer’s report; and

- certain defects in the preparation of the report which that person was or ought to have been aware of.

Subsection (2). Provides that the sanction is recovery by the company of the consideration for the asset or of an amount equal to the value of the consideration.

Subsection (3). Covers the case where the agreement is, or includes, an agreement for the allotment of shares as well as the transfer of an asset to the company. In that case, the provision for the recovery of consideration does not apply to the allotment of shares; but the person concerned is liable to pay the nominal value of the shares and any premium.

It is intended to retain provision on the lines of this section.

Section 106

This provides that shares taken by a subscriber to a public company’s Memorandum in pursuance of an undertaking in the Memorandum, and any premium, must be paid up in cash. The point of this is not that payment up must be in full, but that the consideration must be cash. Payment up in cash includes, in addition to the handing over of actual cash, the giving of a cheque which the directors have no reason to think will be dishonoured, the release of a liability of the company and a promise to pay cash at a future date (section 738(2)).
The provision made by this section will need to be reformulated in terms of the founder shareholders and the shares of each recorded in the new Registration Form (see analysis of company formation). It would also need to take account of any move to an NPV environment. The inclusion in the definition of payment up in cash of a promise to pay at a (possibly far distant) future date may open the door to evasion. More generally, the definition of “cash”, as it applies in all these provisions relating to payment up in cash and non-cash consideration, may require review in the light of the requirements of the Second Directive.

Section 107

This defines the “appropriate” rate of interest for the purpose of the preceding provisions as 5% or such other rate as the Secretary of State by Order provides. No orders have been made under this section despite wide fluctuation in commercial rates over the period, and the need for a statutory provision is unclear. It is proposed to delete this provision and to qualify the rate of interest, where it appears in this Part, with words indicating that a reasonable commercial rate is to be applied. The courts have enough experience of commercial litigation to interpret this if called on to do so.


These sections set out in detail the requirements for the valuation of non-cash consideration for shares of a public company on allotment. They implement Article 10 of the Second Directive.

Article 108

Subsections (1)-(3). Implement the requirement in Article 10.1 that the valuation report should be made by an independent expert “appointed or approved by an administrative or judicial authority”. This is achieved by requiring the report to be made by a qualified company auditor or by a valuer approved by such an auditor. This, by specifying a class of approved valuers, avoids the need for a procedure for case by case approval of the valuer. (This section amplifies section 103 – the case where shares are allotted for non-cash consideration.)
**Subsection (4).** Implements Article 10.2 which provides that the valuation report should include details of the nominal value (or accountable par) of the shares being paid up, including any premium; a description of the non-cash assets used, the valuation method and the date of valuation, and confirmation that the value of the assets corresponds to that of the shares.

**Subsections (5) and (6).** Deal in detail with the case where all or part of the valuation is delegated to another expert.

**Subsection (7).** Covers the case where the non-cash consideration is given both as full payment up for shares and for something else as well.

The use of company auditors, who are covered by a statutory registration scheme, remains the most convenient way of meeting the requirement that the independent expert must be approved by an administrative authority. It is therefore proposed to retain the substance of subsection (1). It is also proposed to retain the substance of subsection (2), confirming the right of the auditor to delegate work to a valuation expert independent of the company. It will also be necessary to retain the substance of subsection (4) in order to ensure compliance with Article 10.2 of the Directive. But subsections (5), (6) and (7) contain detail about the conduct of the valuation which appears to be unnecessary, since a competent expert would take these matters into account anyway. It is therefore proposed to drop these provisions in the interest of simplification.

**Section 109**

This section adapts the detailed provisions of section 108 for the case where a company, within two years of incorporation or commencement of business, acquires from a founder shareholder an asset for a consideration of at least one tenth of the subscribed capital (section 104).

**Subsection (1).** Applies subsections (1)-(3) and (5) of section 108 for the purposes of section 104.

**Subsection (2).** Adapts section 108(4) – on the content of the valuation report – for the purposes of section 104.
Subsection (3). Covers the case where consideration is given to the company in part for the transfer of an asset in the circumstances covered in section 104, and in part for something else.

It will be necessary to apply the new provisions corresponding to section 108(1),(2) and (4) to the case dealt with in section 104. But it is proposed to drop section 109(3), which appears to be unnecessary for the same reasons as section 108(7).

Section 110

This section gives the valuer the right to require information from officers of the company (subsection (1)) and provides criminal sanctions for the knowing or reckless giving of false or misleading information (subsection (2)). Subsection (3) defines the class of statement which, if false or misleading, will attract these sanctions.

It is proposed to retain provisions on the lines of subsections (2) and (3); these seem necessary to reduce the risk that valuations will be made on the basis of false information, and criminal penalties seem appropriate where dishonesty or recklessness in involved. But it is for consideration whether the valuer needs a statutory right to require information provided in subsection (1). If he is not given voluntarily all the information he needs, he can simply refuse to issue the valuation report.

Section 111

This section implements the requirement in Article 10.3 of the Second Directive for publicity for the valuation report where shares are allotted for non-cash consideration, and, as required by Article 11.1, extends the requirement to the valuation report under section 104.

Subsection (1). Requires a copy of the valuation report made under section 108 to be delivered to the registrar along with the return of allotments required under section 88.
Subsection (2). Requires a resolution passed under section 104 to be delivered to the registrar, together with the valuation report required under that section. Subsections (3) and (4) provide the normal penalties for default in respect of registration requirements (a “one off” fine followed by daily default fines on the officers responsible for a breach of subsection (1) and on both the company and the officers responsible for a breach of subsection (2)).

The registration requirements are clearly necessary and it is proposed to retain them. It is also proposed to retain penalties for default against the officers of the company; the nature of the penalties on individuals here and elsewhere will be considered separately. But it is proposed to drop the provision for penalties on the company here and in a number of other cases; it seems inappropriate to penalise the company, and thus reduce the value of the investment of the innocent shareholders, for the default of individual officers.

Other matters arising out of allotments, etc

Section 111A

This section was introduced in the 1989 Act and reverses the decision of the House of Lords in the 1880 case Houldsworth v. City of Glasgow Bank; that case apparently established that a shareholder could not recover damages from a company unless he first ceased to be a member. It is proposed to retain the provision.

Section 112

This section deals with the case where the original allottee was financially liable as a result of a breach of one of the requirements for share allocations, but the shares concerned have already been transferred, by sale or otherwise, to new holders. The requirements concerned are as follows:
section 99 – company not to accept, as payment up, an undertaking to provide services;

section 100 – shares not to be allotted at a discount;

section 101 – shares in a public company not to be allotted except one quarter paid up;

and

section 103 – shares in a public company not to be allotted for non-cash consideration unless a valuation report is produced and sent to the allottees.

In each of these cases the initial allottee is liable to pay the whole of the nominal value, and premium, in cash and with interest.

Subsection (1). Sets out the basic rule that in case of a breach of the above provisions a subsequent holder of the shares is liable jointly and severally with the original holder.

Subsection (2). Makes similar provision for the liability of a subsequent holder where an agreement is made, contrary to section 104, ie where a company, within two years of incorporation or commencement of business, acquires from a founder shareholder an asset for a consideration of at least one tenth of the subscribed capital, the consideration includes an allotment of shares, and the conditions relating to a valuation report are not met.

Subsection (3). Exempts from liability under subsections (1) and (2) a purchaser of shares for value without actual notice of the breach, and a person acquiring the shares from someone who is not so liable.

Subsection (4). Gives the same broad definition of a shareholder for the purposes of section 112 as is included in section 99(5) (on which, see comment above).

Subsection (5). Extends the liability of a subsequent holder under subsection (1), and the exemptions under subsection (3), to the cases under section 102 where the consideration for an allotment of shares is the performance under an agreement of an obligation more than five years ahead, and where an obligation less that five years ahead is not in fact performed within five years. (See comment above on section 102(3)-(7).)
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It is necessary to retain the effect of the above provisions in order to forestall the avoidance of liability in the above cases by an initial allottee passing on shares collusively to eg an associate or family member.

Section 113

This section provides in detail for circumstances in which the court should have discretion to relieve the liabilities of initial allottees and subsequent holders under the above provisions, and to adjust liability between contributors.

Subsection (1). Provides generally for persons liable under the above provisions to apply to the court to be relieved of their liability.

The remaining subsections make detailed provision for different types of liability and for the factors to be taken into account by the court in each case.

A distinction is made between the case where a liability arises “in relation to payment in respect of shares” (subsection (2)) and the case where liability arises “by virtue of an undertaking given to the company in, or in connection with, payment for shares in it” (subsection (4)). In each case, the court may give relief if and to the extent that it appears just and equitable to do so, having regard only to specified factors. These are set out in subsections (3) and (5) respectively. These factors appear to be ones to which a court would, as a matter of common sense, have regard anyway.

Subsections (6) and (7). Extend the provision the court’s discretion to actions for contribution between persons liable under the sections concerned. Subsection (8) extends the discretion to grant relief to the case where a person is liable under section 105(2) (recovery of an asset or equivalent payment).

It is proposed to retain a provision enabling the court to grant relief in the circumstances set out in subsection (1); but subsections (2)-(8) seem unnecessarily detailed. It is therefore proposed to replace these subsections with a simple provision giving the court a broad discretion in those circumstances to grant relief from liability, and to adjust liability between contributors, where it seems just and equitable to do so.
Section 114

This section provides for fines for contravention of the above sections by companies and their officers. It is proposed to retain appropriate penalties against the officers but to drop penalties against the companies (see note on section 111 above).

Section 115

This section makes clear that even where acceptance of an undertaking as consideration for an allotment of shares contravenes the above provisions, the undertaking itself remains enforceable. Subsection (1) applies this principle to undertakings to do work or perform services despite contravention of sections 99, 102 or 103. Such undertakings are enforceable by the company.

Subsection (2). Covers the case of an agreement which contravenes section 104 in respect of the allotment of shares. The provisions of such an agreement remain enforceable by either side, notwithstanding the contravention.

This seems good policy, and it is proposed to retain the substance of the provision.

Section 116

This section applies sections 99-115 to private companies and joint stock companies which have resolved to reregister as public companies but have not yet done so. A joint stock company is defined in section 683; these are companies having the characteristics of a company limited by shares and either in existence before 2 November 1862 or formed after that date other than under the Companies Act. A provision on these lines should be retained, but the exclusion for cases transitional at the time of the 1980 Act now appears to be spent.
Sections 117-124: General provisions about share capital

Section 117: Public company share capital requirements

This section provides a mechanism for creating a public company from scratch, as distinct from the reregistration of a private company. It ensures that companies formed as public companies cannot commence business without the necessary minimum share capital (see section 118). In CA1985, the section appears under “General Provisions About Share Capital”, but apart from subsection (4) the matters it deals with more logically fall to be considered under company registration. Accordingly, subsections (1)-(3) and (5)-(8) have been dealt with in Chapter 2 and Annex A.

Subsection (4). Provides that while shares issued in pursuance of an employees’ share scheme do not have to be paid up (see under section 101(2) above), such shares cannot count towards the authorised minimum unless they are paid up. This is a plausible interpretation of the Second Directive, which is not explicit on the point, and the provision should be retained. It would fit well enough as a qualification to the new provision on the authorised minimum (see below).

Section 118: The authorised minimum

Subsection (1). Sets the minimum allotted share capital of a public company at £50,000 or such other sum as the Secretary of State may specify by Order. The minimum set in Article 6.1 of the Second Directive is 25,000 euros. A minimum of at least this figure must be retained. As part of its consultation on the redenomination of share capital (see below under section 121), the Department is consulting on a proposal to permit public companies to maintain their authorised minimum in the form of share capital denominated in a currency other than sterling.

Subsection (2). Sets out what an order changing the authorised minimum may contain. Under paragraph (2)(a) a company with an allotted share capital lower than a new (increased) minimum may be required either to increase its allotted capital at least to the new figure or to reregister as a private company. Paragraph (2)(b) states that the order may deal with any of a number of matters for which provision is made in the Act. These include registration or reregistration;
The scope of the order making power needs to be as wide as is set out in subsection (2). The point in paragraph (2)(a) is worth singling out; but there may be scope for simplifying the section by replacing (2)(b) and (2)(c) by a single broad power to include supplemental and transitional provisions. It would also be prudent to frame the power so as to accommodate a possible future agreement to redefine the authorised minimum in terms of subscribed share capital rather than nominal capital.

Section 119: Provision for different amounts to be paid on shares

This section provides that the following are permitted if authorised by the company’s Articles. Paragraph (a) permits arrangements to be made on an issue of shares for a difference between shareholders in the amounts or times of payments or calls. Paragraph (b) permits the whole or part of the amount remaining unpaid to be paid although it has not been called up. Paragraph (c) permits a dividend to be paid in proportion to the amount paid up on each share where a larger amount is paid up on some shares than others. The “default” Articles in Table A 1985 take advantage of (a) and (c) (Table A, 1985, paragraphs 17 and 104) but not of (b).
This section derives from section 59 of the 1948 Act. But we believe that, as a matter of common
law, the presumption of equality between shareholders can be displaced by the Articles. If so,
statutory provision is superfluous, and accordingly it is proposed to drop this provision.

Section 120: Reserve liability of limited company

This section provides that a company may determine by special resolution that any part of its
share capital not already called up shall not be called up except in a winding up.

The purpose of this section, which goes back to the nineteenth century, is to establish that a
company may establish a fund of irrevocably uncalled capital by special resolution. Gower
considers that long term uncalled capital is “virtually a thing of the past” (Principles of Modern
Company Law, Sixth edition, pp. 237-238). It is thought that this provision is no longer relevant
or necessary and it is proposed to drop it, if necessary with savings for existing companies.

Section 121: Alteration of share capital (limited companies)

Subsection (1). Provides that a company limited by shares, or a company limited by guarantee
with a share capital, may, if so authorised by its Articles, alter its share capital in any of the ways
set out in subsection (2). The subsection is drafted in terms of alterations to the conditions in the
Memorandum relating to share capital. The share capital referred to appears to be authorised
share capital in the case of subsection (2)(a) and (e), issued share capital in the case of subsection
(2)(c), and both authorised and issued share capital in the case of subsection (2)(b) and (d).

Subsection (2). Sets out the ways in which the share capital may be altered under this section.
Paragraph (a) permits a company to increase its (authorised) share capital by new shares of
such amount as it thinks expedient. Paragraph (b) permits the company to consolidate or divide
all or any of its shares (whether issued or not) into shares of larger amount than its existing
shares. Paragraph (c) permits the company to convert any or all of its paid up shares into stock
and reconvert the stock into paid up shares. Paragraph (d) permits the company to subdivide its
shares, or any of them, (whether issued or not) into shares of smaller amount than is fixed by the
Memorandum. Paragraph (e) permits the company to cancel shares which have not been taken,
or agreed to be taken, by anyone, and to diminish the amount of the company’s (authorised) share capital accordingly. (This subsection does not at present provide for the redenomination of shares from one currency into another currency. This was the subject of the Department’s Consultation Document “The Euro: Redenomination of Share Capital” issued in January 1998. The Department is considering the responses to this Document.)

**Subsection (3).** Provides that in any subdivision under subsection (2)(d) where shares are not fully paid, the proportion between the amounts paid and unpaid must be the same for the new, reduced value shares as for the original shares.

**Subsection (4).** Provides that the powers conferred by the section must be exercised in general meeting. (But note that an ordinary resolution will suffice.)

**Subsection (5).** Provides that a cancellation of shares under (2)(e) shall not constitute a capital reduction (and thus be subject to the more stringent conditions set out in sections 135ff).

It is intended to retain the substance of this section – that decisions on alterations in capital (other than reductions – dealt with separately) are for the shareholders – since only their interests are directly affected. But the abolition of the concept of authorised share capital (suggested in the analysis of “company formation”) would make possible a substantial simplification of subsections (1) and (2) for both private and public companies, on the following lines.

A company would be enabled (subject to any contrary provision of its constitution) to consolidate any number of shares into a smaller number; and to divide any number of shares into a greater number (subsections (2)(b) and (d)).

Subsection 2 (a) will fall with the abolition of authorised share capital. It is for consideration whether the power to convert shares into stock and vice versa (subsection (2)(c)) should be retained (the Jenkins Committee in the 1960s recommended that it should be dropped); and the cancellation of unissued shares (subsection (2)(e)) will have no meaning with the disappearance of authorised share capital.

It is proposed to retain the safeguard in subsection (3).
The requirement in subsection (4) that the decision must be taken in general meeting is unusual. It does not override the power of a private company to take such decisions by unanimous written resolution (section 382A(1)). But it appears to prevent a public company from doing so when, without such an express provision, it probably could (see discussion in Gower, 6th Edition, p.176). It is proposed that the requirement should simply be that the powers conferred by the section must be exercised by an (ordinary) resolution.

The clarification in subsection (5) should probably be retained for the avoidance of doubt.

Section 122: Notice to registrar of alteration

Subsection (1). Provides that where a company alters its share capital in specified ways, it shall within one month give notice to the registrar in the prescribed form. The types of alteration covered include those in section 121 (2)(b)-(e), and in addition the cancellation of shares following their acquisition in pursuance of a court order (section 143(3)(c)), their forfeiture for failure to pay up (section 143(3)(d)) or their acquisition with financial assistance from the company in the circumstances set out in section 146 (1)(c) and (d), the redemption of redeemable shares (section 160) and the cancellation of shares on buy back (section 162). (Notice of an increase in share capital under section 121(2)(a) is dealt with in section 123 – see below.)

Subsection (2). Provides for fines, including daily default fines, on the company and any officer for breach of subsection (1).

The requirement to notify the registrar of the various types of alteration in share capital should be retained. (If it is decided to drop section 121(2)(c) on the conversion of shares into stock and vice versa, section 122(1)(b) and (c) will fall as a consequential.)

It is proposed to retain appropriate penalties against the officers but to drop penalties against the company (see note on section 111 above).
Section 123: Notice to registrar of increased share capital

Subsection (1). Provides that, where a company increases its share capital beyond the registered capital, it shall within 15 days of the passing of the relevant resolution give the registrar notice of the increase; the registrar must then record it. It is clear that, although the registered capital is stated in the Memorandum (section 2(5)(a)), it may be altered by ordinary resolution (see section 121(2)(a) and (4)). The reference to “registered capital” is presumably to section 2(5)(a) “the Memorandum must .....state the amount of share capital with which the company proposes to be registered” – ie the authorised share capital.

Subsection (2). Provides that the notice to the registrar must include prescribed particulars of the classes of shares affected and of the conditions subject to which the new shares have been or are to be issued.

Subsection (3). Provides that a copy or the resolution authorising the increase must be forwarded to the registrar with the notice. The resolution must be printed or in such other form as is prescribed by the registrar.

Subsection (4). Provides for fines, including daily default fines, on the company and any officer for breach of the section.

Given the decision to abolish authorised share capital, this provision cannot stand in its present form. It would be possible instead to provide that when a company decides to authorise the issue of new shares, the company shall deliver to the registrar a copy of the resolution authorising the increase (as in the present section 80(8)). This would complement the return of allotments required by section 88 after shares are actually allotted, and in the case of public companies would implement the requirements of Article 25.1 and 2 of the Second Directive. In the case of private companies, however, it is considered that it is unnecessary to require publicity in advance for a decision to increase the issued share capital, and that publicity after the event through the returns of allotment should suffice. Accordingly, it is proposed to drop section 123 for both public and private companies, and section 80(8) for private companies. Any information currently specified pursuant to section 123(2) or section 80(8) can be required to be notified instead under section 88. In the case of shares with special rights, it is thought that section 128(1) will ensure the notification of the relevant information.
Section 124: Reserve capital of unlimited company

This section addresses the situation where an unlimited company with a share capital reregisters as a company limited by shares, whether public or private. The section provides that in such a case the company may increase its capital subject to the condition that the increase may not be called up except in a winding up. The increase in share capital can be achieved either by increasing the nominal value of each share (paragraph (a)), or by setting aside a specified portion of the share capital (paragraph (b)).

Since we have taken the view on section 120 that it is no longer necessary to provide for long term uncalled share capital, it is logical to take the same view here. It is therefore proposed to drop section 124.

Sections 130-134: Share premiums

These sections provide that where a company issues shares at a premium to their nominal (par) value, the amount of the premium is to be transferred to a share premium account. They set out the purposes to which the share premium account may be applied, and provide certain reliefs from the obligation to transfer premiums to the share premium account.

It is proposed to abolish par value shares for private companies and – if the necessary amendment of the Second Directive is made – also for public companies. The result will be to replace share capital and share premium as separate balance sheet items, with different rules for their application, by a single item including all subscribed share capital. The general rule will be that the procedure for capital reduction (see below) will then apply to all reduction of subscribed share capital, regardless of whether it was subscribed as par value or as share premium. (For the purposes of this analysis, it is assumed that either private companies will be required to convert par value shares to NPV, or existing par value shares will be deemed to be NPV – see Consultation Document “Modern Company Law for a Competitive Economy; the Strategic Framework” (the Strategic Consultation Document) paragraph 5.4.31.) Provisions dealing with the establishment and application of the share premium account as such will need to be retained, if at all, for public companies only. But there will be an economic case for retaining some of the
permitted applications of the share premium account as permitted applications of subscribed share capital in the new NPV environment.

Section 130: Application of share premiums

Subsection (1). Provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate of the premiums shall be transferred to a share premium account. This provision will be retained for public companies only.

Subsection (2). Provides ways in which the share premium account may be applied in which nominal capital may not. These are:

- for paying up unissued shares to be allotted to members as fully paid bonus shares;
- in writing off the company’s initial expenses;
- in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; and
- in providing the premium payable on redemption of debentures of the company.

It is proposed to permit the first for public companies if par value has to be retained. It merely converts share premium to share capital and involves no reduction in undistributable reserves. (In an NPV environment, the issue of new shares as bonus shares involves merely the reapportionment of a given quantum of subscribed share capital, without any need for payment up out of reserves.) The writing off of expenses does however represent a real reduction in undistributable reserves, whether in the form of subscribed share capital or share premium. The Strategic Consultation Document suggests as a principle here that the reserve established on the issue of share capital should be at least equivalent to the net proceeds of the issue (5.4.32). It is therefore proposed to permit the subscribed share capital, (or, as the case may be, the share premium account) to be applied in writing off the expenses of, or commission paid or discount allowed on, any issue of shares of the same class; but not in writing off the company’s initial expenses or the expenses etc of an issue of shares of a different class or of debentures; or in providing the premium on redemption of debentures.
Subsection (3). Provides that apart from the applications permitted by subsection (2), the share premium account must be maintained in exactly the same way as the (nominal) share capital. This provision is redundant in an NPV environment; it is proposed to retain it for public companies.

Subsection (4). Points forward to the reliefs provided by sections 131 and 132.

Sections 131-134

These sections provide relief from the obligation to transfer premiums arising from the issue of shares to the share premium account. They relate to the issue of shares at a premium in return for the transfer or cancellation of another company’s shares in the context of a merger (section 131) and for the transfer of another company’s non-cash assets in the context of a group reconstruction (section 132). These provisions were introduced in the 1981 Act in response to representations from the CBI and the Law Society, following court decisions that premiums had to be transferred to the share premium account in such cases. The argument was that the result of the decisions was to convert distributable reserves of one of the companies party to the transaction into undistributable reserves of the company resulting from the transaction.

These reliefs could not be retained in their present form in an NPV environment; the relief would have either to be extended to the whole of the subscribed share capital account, or abandoned completely. The case for retaining the relief in the more generous form is considered separately under sections 131 and 132.

Section 131: Merger relief

Subsection (1). Provides that the section applies (other than for a group reconstruction dealt with under section 132) where company A has secured at least a 90% equity holding in company B in pursuance of a transaction with the following characteristics: shares in A are allotted in consideration either for the issue or transfer to A of shares in B; or for the cancellation of shares in B not held by A.
Subsection (2). Provides that if A issues its shares at a premium in a transaction as described in subsection (1), section 130 does not apply to the premium – ie it need not be transferred to the share premium account.

Subsection (3). Extends the relief to the case where the consideration for the issue of A’s shares includes the issue, transfer or cancellation of non-equity shares in B. (Equity and non-equity shares are defined in subsection (7) – qv).

Subsection (4). Makes clear that it does not matter whether the transaction is one involving the acquisition of over 90% of B’s shares in one go, or whether it involves the increase of A’s earlier partial holding to one of over 90%.

Subsection (5). Provides that where B’s shares are divided into several classes, A must acquire at least 90% of each class to enjoy the relief provided by subsection (2).

Subsection (6). Provides that shares (in B) held by another member of the group of which A is a member, or by nominees of A or of another member of the group, count as shares held by A for the purposes of the section.

Subsection (7). Defines “equity shares”, “non-equity shares” and “arrangement” for the purpose of the section. “Equity shares” are defined as shares comprised in the company’s equity share capital, which is in turn defined in section 744 as “...issued share capital excluding any part of that capital which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in distribution”. “Arrangement” is widely defined to include not only a commercial transaction but also a court sanctioned arrangement under section 425 or section 110 of the Insolvency Act 1986.

Subsection (8). Excludes from relief cases where the issue of shares took place before 4 February 1981.

The effect of such a relief in an NPV environment would be to permit company A to increase its reserves by the whole of the consideration (and not just the premium) for company B’s shares. This could result potentially in a substantial erosion of the share capital of company A post merger, compared with that of A and B beforehand, without creditor safeguards. Taking account
of the less onerous procedure now proposed for capital reduction (see below) it is for consideration whether it is necessary to retain merger relief, in respect of the whole consideration for company B’s shares, in an NPV environment. An alternative might be to provide that the amount to be transferred to subscribed capital is the amount of the book value of the other company’s capital and reserves attributable to the shares acquired or cancelled. For public companies, where the relief extends only to the premium, the case for retaining the present relief is somewhat stronger. (One possibility would be to offer public companies the choice either of the present relief or of the amount applicable for a private company, whichever is the greater.)

Section 132: Relief in respect of group reconstructions

Subsection (1). Defines the application of this section. It applies where the company issuing shares (A) is a wholly owned subsidiary of another company (the holding company H); and A allots its shares either to H or to another wholly owned subsidiary (S) in consideration for the transfer to A of non-cash assets of another member of the group (B), which also needs to be a wholly owned subsidiary.

Subsection (2). Provides that where A’s shares are allotted at a premium in the arrangement at subsection (1), some of the premium is exempt from transfer to the share premium account. The exempt portion is the excess of the premium over the “minimum premium value”. The next three subsections define what this is.

Subsection (3). Defines the “minimum premium value” as the amount, if any, by which the “base value” of the consideration (represented by B’s net assets) for the shares exceeds the nominal value of those shares.

Subsection (4). Provides that the base value of B’s assets transferred to A means the base value of the assets less the base value of any of B’s liabilities assumed by A as part of the transaction – ie the base value used in the calculation of minimum premium value is a net figure.

Subsection (5). Defines “base value” both for assets and liabilities. For assets it means the lower of cost or the amount at which they are stated in the transferor’s (H or B) accounting records immediately before the transfer. For liabilities it means the amount at which they are stated in the transferor’s (H or B) accounting records immediately before the transfer.
Subsections (6) and (7). Deal with transactions which took place before this section took on its present form in 1984. The need for such provisions could be avoided by ensuring that the operative provision applies only to future transactions.

Subsection (8). Confirms that for the cases described in subsection (1), it is this section, not section 131, which is operative.

To achieve a similar effect as the above for an NPV environment it would be necessary to replace subsections (2), (3) and (4) above with a provision that in the situation described in subsection (1), the subscribed share capital was to be increased by the base value of the assets transferred as defined in subsection (5). This would provide a degree of built in safeguard against the erosion of share capital involved in merger relief, and it is accordingly proposed to include a provision in this modified form for relief in respect of group reconstructions. If nominal value must be retained for public companies, it is intended to retain the substance of the present section 132.

Section 133: Provisions supplementing sections 131 and 132

Subsection (1). Provides that where under section 131 or 132 all or part of a premium on the issue of shares is not transferred to the share premium account, that part may also be disregarded in determining the amount at which any shares or other consideration for shares are included in the company’s balance sheet.

Subsection (2). Provides that references to the acquisition of shares in another company, and to the issue or allotment of shares to, or the transfer of shares to or by, a company, include references to the acquisition etc to or by a nominee of the company.

Subsection (3). Provides that references in the Chapter to the transfer of shares in a company include references to the right to be included in the register of members in respect of those shares.

Subsection (4). Provides that all references to a company in sections 131-133, other than those to the issuing company, include any body corporate.
For private companies, and for public companies if nominal value is not retained, it is intended to recast the provision so that where all or part of the value of the consideration for the issue of shares under the provision for group reconstruction relief is not transferred to the subscribed share capital account, that amount may also be disregarded in determining the amount at which any shares or consideration for shares are included in the company’s balance sheet. If par values remain for public companies, it is intended to retain a provision on the lines of the present section 133(1).

It is intended to retain provisions on the lines of the present subsections (2), (3) and (4)

**Section 134: Provision for extending or restricting relief from section 130**

**Subsection (1).** Permits the Secretary of State to make regulations to restrict or extend the reliefs provided by sections 131 and 132, or to introduce new reliefs from the obligation to transfer premiums on the issue of shares to the share premium account.

**Subsection (2).** Provides that the regulations may make different provision for different cases, and contain incidental and supplementary provisions.

**Subsection (3).** Provides for the regulations to be subject to affirmative resolution procedure in both Houses.

The future of such order making powers will be examined as a general topic later in the Review.

**Sections 135-141: Reduction of share capital**

The Strategic Consultation Document (paragraphs 5.4.4-5.4.13) suggested that, for private companies, the present requirement for prior court approval of a capital reduction should be replaced by a requirement for a special resolution, coupled with a solvency declaration by the directors. For public companies, in order to comply with the Second Directive it would be necessary to allow creditors to challenge the proposed reduction in the courts on the grounds that they were being offered neither security nor adequate safeguards, and that the state of the company’s assets was not sufficient to make safeguards unnecessary. But these additional
safeguards for creditors appear not to be required where the purpose of the reduction is to write off losses. It is proposed to implement this scheme in the following way.

Section 135

This deals with the internal company procedure for initiating a reduction of capital.

Subsection (1). Provides that a company (public or private) limited by shares, and a company limited by guarantee with a share capital, may, if so authorised by its Articles, by special resolution reduce its share capital in any way. The reduction would then be subject to confirmation by the court.

Subsection (2). Indicates the main ways in which a company may reduce its share capital under the section (for which purposes the share premium account is treated as if it were part of paid up share capital – see section 130(3)). They are:

- by reducing or eliminating shareholders’ liability in respect of share capital not paid up;
- by cancelling any paid up share capital which is lost or unrepresented by available assets (ie capital reduction to write off losses). Such a reduction can include the reduction or elimination of liability in respect of share capital not paid up; and
- by paying off share capital which is in excess of the company’s wants.

The subsection also provides that on a reduction the company may alter its Memorandum by reducing the amount of its share capital and of its shares accordingly.

Subsection (3). Provides that a special resolution under the section is referred to throughout the Act as “a special resolution for reducing share capital”.

It is proposed to remove the requirement in subsection (1) for court confirmation in every case (see below under sections 136 and 137). The requirement for a special resolution must be retained for public companies to comply with Article 30 of the Second Directive and it is proposed to require it for all companies covered by the subsection. (In the event that a proposed reduction discriminated between shareholders of different classes, it is assumed that this would
constitute a change of class rights and be subject to approval in separate class meetings without the need for special provision here.)

It is proposed to retain the reference in subsection (2) to three different ways of reducing share capital, since it is suggested below that they should be treated differently in the case of public companies. The reference to the alteration of the Memorandum should be replaced with one to the alteration of the details of the share capital with which the company is at the relevant time registered. (See analysis of company formation, under section 10(2).)

Sections 136 and 137. Deal with the present requirement for prior court approval, for the court’s procedure, and for order which the court may make confirming the reduction, with or without conditions. It is proposed that these sections should be replaced with provision for a solvency statement by the directors (all companies), and for a right of creditors to challenge the reduction before the court (public companies only). These are described in new Provisions A and B below. The publicity requirements will also be different under the regime proposed. These are dealt with under section 138 below.

New provision A – Solvency statement

It is suggested that provision should be made as follows:

- the solvency statement should take the form of a simple formal declaration, not a statutory declaration;

- it should state that the directors have formed the opinion, as regards the company’s situation immediately after the reduction takes effect, that:

  a) if it is intended to commence a winding up within 12 months, the company will be able to pay its debts in full within 12 months of the commencement;

  b) otherwise, the company will be able to pay its debts as they fall due during the year after the reduction takes effect;
in forming their opinion, the directors should be required to take into account the company’s liabilities, including contingent and prospective liabilities;

there would be penalties for directors who make a solvency statement knowing that there are no sufficient grounds for their opinion, or reckless as to whether there are sufficient grounds or not. If provision needs to be made here, the penalties might include a fine and imprisonment (cf. CA1985, section 156(7)); it is for consideration whether they should also include personal liability for any losses resulting to creditors; and

if (but only if) a company has auditors, the auditors should be required to say, if they properly can, that they have enquired into the state of the company and that they are not aware of anything to indicate that the directors’ opinion is unreasonable in all the circumstances. This statement should be annexed to the directors’ solvency declaration.

New provision B – Right of a creditor to object to the reduction

It is suggested that provision should be made as follows:

this provision should apply only in the case of a capital reduction by a public company. (Creditors of a private company would thus have to rely on the solvency declaration);

it would apply to all forms of reduction except those whose purpose is to write off losses. This would take advantage of the Member State option in Article 33 of the Second Directive. It is suggested that the new provision should also take advantage of the provision in that Article permitting a Member State to exempt from the procedure reductions which create an undistributable reserve of not more than 10% of the reduced capital;

the right to object would extend to any individual creditor. There would be no threshold in terms of the number of objectors or the amount of debt;
• the grounds for objection would be that the proposed reduction did not offer the creditor security for his debt, or other sufficient safeguards, and that the assets of the company were not sufficient to make these unnecessary;

• there should be a gap between the passing of the special resolution to reduce capital and its taking effect, to give creditors an opportunity to object. Four weeks might be appropriate (cf. section 158(2)). The period should start with the publication of the resolution (see under section 138 below);

• the reduction would be put on hold pending the court’s decision;

• the court could permit the reduction to go ahead without conditions, or permit it subject to conditions designed to protect some or all of the creditors, or prohibit the reduction. (The provision in section 137(2) permitting the court to add the words “and reduced” to the company’s name need not be retained.) Where the court sets conditions, it is for consideration whether it should be required to take account of the need not to impose more onerous burdens on the company than necessary. It does not seem necessary to specify the matters to which the court should have regard. Nor does it seem necessary to retain an express provision enabling the court to require the company to publish reasons for the reduction, or other information (section 137(2)(b)); this would be covered by the general power to make approval conditional; and

• where the court permitted the reduction to go ahead without conditions, the objector(s) would be liable, at the court’s discretion, for all or part of the company’s costs.

Section 138: Registration of order and minute of reduction

This section deals with the registration of the court order which must under the present law approve the reduction, and of a minute recording the details of the new reduced capital. These provisions are not applicable to the new arrangements proposed above, so a new provision on publicity and registration will be needed.
New provision C – Publicity and registration

It is suggested that provision should be made as follows:

- when a company intends to propose a special resolution to reduce capital, the notice of the meeting must mention the proposed resolution, and specify the purpose of the reduction and the way in which it is to be carried out. (This implements Second Directive, Article 30.2 for public companies, but is arguably desirable for all types of company in the absence of an obligatory court procedure);

- a copy of a special resolution approving a reduction of capital must be delivered to the registrar and registered by him without the need for special provision here. (This requirement will implement, Article 30.1 of the Second Directive for public companies.)

It is suggested that a copy of the solvency statement and the auditors’ report should also be delivered for registration. Also, since the onus of challenging the reduction will now fall on the creditors of a public company, it is suggested that a public company should, in addition be required to publish a resolution to reduce capital in (say) three national newspapers. (Publication on the Internet may eventually be acceptable as the default here, but not yet);

- when the court has approved a reduction by a public company with or without variation, the company should be required to notify the registrar of that fact, together with details of its new share capital if different from that originally notified (see above);

- the registrar should be required to register each of the above documents delivered to him; and

- the reduction should be deemed effective on registration of the details on the Companies Register.
Section 139: Public company reducing capital below the authorised minimum

The purpose of this section is to ensure that a reduction of capital by a public company, which brings the capital below the authorised minimum, cannot become effective unless the company first reregisters as a private company. A provision on these lines is still needed, but the section is drafted in terms of the present role of the court.

It is proposed to simplify the provision by providing that a public company may not resolve to reduce its capital below the authorised minimum. The effect will be to compel a public company wishing to do so first to reregister as a private company. The prohibition would be supported by penalties on an officer of the company in default.

Section 140: Liability of members on reduced shares

This section deals with the liability of members in the case where the capital reduction has taken the form of the reduction or extinguishing of the liability to pay up an amount unpaid on the shares.

Subsection (1). States the normal rule that the member has no liability to pay up the difference between the original amount unpaid on his shares and the new reduced amount following the reduction. The substance of this should be retained. But the original and new amounts will have to be redefined in the terminology of the new arrangements (the wording “the amount of the share as fixed by the minute” will no longer fit).

Sections (2) – (5). Make an exception to the rule in subsection (1) for the case where a creditor’s claim is overlooked when a list of creditors is compiled for the present obligatory court procedure, and the company becomes insolvent before the claim can be met. Now that it is proposed to place the onus on creditors to object to the reduction within a specified time, the situation envisaged in these subsections cannot arise. However, a creditor might be left in ignorance of the proposed capital reduction by a failure to advertise as proposed above under New Provision C. It is suggested that such a creditor should be able to apply to the court for safeguards of the sort which might have been imposed had he been able to respond in timely manner to an advertisement.
Section 141: Penalty for concealing name of creditor etc

This section provides a penalty for breach of the obligation on the company implicit in section 137 to co-operate with the court in establishing a definitive list of creditors. The only comparable obligation in the arrangements now proposed is to advertise the proposed capital reduction. Failure to do so might render the officer of the company responsible liable to a fine. It is also proposed that where a company reduces its capital contrary to the provisions set out above, including where the directors’ solvency declaration was made without reasonable grounds to believe in its truth, any director or shareholder knowingly party to the default should be liable at the suit of a creditor to pay up the capital reduced.

Sections 142-150: Maintenance of capital

Section 142: Duty of directors on serious loss of capital

This section implements Article 17 of the Second Directive.

**Subsection (1).** Provides that where the net assets of a public company are half or less of its called up share capital, the directors shall, within 28 days of a director becoming aware of the fact, convene an EGM for a date not more than 56 days later for the purpose of considering what steps, if any, to take to deal with the situation. (Article 17 requires the meeting specifically to consider whether the company should be wound up or any other measures taken. The “steps” in subsection (1) no doubt include winding up. It is also noted that “net assets” is not defined for the purposes of this subsection.)

**Subsection (2).** Provides for a fine on any director who wilfully authorises or permits a failure to comply with subsection (1).

**Subsection (3).** Included for the avoidance of doubt, makes clear that nothing can be considered at the EGM convened under subsection (1) that could not have been considered at an EGM anyway.
These provisions implement Article 17 minimally and do not apply to private companies. The obligation to hold an EGM in these circumstances seems pointless, first because the fact that the value of net assets has fallen below half (or any other proportion) of the called up share capital may not in itself indicate that the company’s situation is critical; and second because no action can be taken at an EGM called in response to this requirement which could not be taken at a general meeting anyway. If Article 17 remains in its present form, it is proposed to continue its present minimal implementation, for public companies only.

**Section 143: General rule against company acquiring own shares**

Before 1980 it was held as a general rule of common law, subject to exceptions, that a company could not acquire its own shares. Such a rule, and the exceptions to it, were codified for public companies in Articles 18-22 and 24 of the Second Directive and in the Companies Act 1980 which implemented those provisions for all limited companies with a share capital.

**Subsection (1).** Provides that a company with a share capital may not acquire its own shares by subscription, purchase or otherwise. This general prohibition is expressed to be subject to the following provisions – ie the following sections up to section 181.

**Subsection (2).** Provides the sanction for a breach of subsection (1) not covered by any of the exceptions. The acquisition itself is void, hence the reference to the “purported acquisition”.

In addition, the company or any officer in default is liable to imprisonment, a fine or both.

The reason for the prohibition is that such acquisitions deplete the company’s assets. It is therefore unclear why the company’s innocent shareholders (and employees) should suffer a fine which depletes the assets further. It is suggested that penalties should be confined to the officers of the company. The consequences of the voidness of the acquisition is that title does not pass to the company, and the purchaser will be obliged to return the purchase money. Where the shares had been sold on, even to an innocent third party, that transaction too would presumably be void. It is proposed to remove the voidness provision, and rest with the penalties on the company’s officers.
Subsection (3). Provides a series of exceptions from the prohibition in subsection (1). These are:

- a redemption or purchase of shares in accordance with Chapter VII of Part V of the Act (sections 159-181 qv);

- an acquisition of shares in a reduction of capital duly made. (For proposed new safeguards, see on sections 135-141 above);

- the purchase of shares in pursuance of a court order made under provision relating to alteration of objects, litigated objection to reregistration of a public company as private, and relief to members unfairly prejudiced. (The first of these will disappear as a consequence of the proposed abolition of the Memorandum and hence of the court procedure for the alteration of objects in it – see analysis of company formation, on sections 4-6. The other two should be retained provisionally pending consideration in the Review of the relevant provisions of the Act); and

- forfeiture of shares, or acceptance of shares in lieu, for failure to pay any sum payable in respect of the shares. (This was a long standing exception to the common law rule.)

These exceptions are covered by Articles 19 and 20 (a), (d) and (e) of the Second Directive.

Subject to the deletion of the reference to a court order relating to the alteration of a company’s objects, it is proposed to retain them.

Section 144: Acquisition of shares by company’s nominee

The holding of shares in a company by a nominee acting for the company, and hence the acquisition of the company’s shares by such a nominee, is not in itself prohibited, though the giving of financial assistance by the company to the nominee for that purpose of course is. This section deals with the case where the nominee subscribes for, or acquires, partly paid shares and fails to pay them up. It implements for public companies Article 18.2 and 3 of the Second Directive.
Subsection (1). Provides that in such a case the shares shall be treated as held by the nominee on his own account, and the company regarded as having no beneficial interest in them (v. Article 18.2). This is subject to the exceptions in section 145, for which see below.

Subsection (2). Deals with the case where the nominee has subscribed for or acquired partly paid shares and fails to pay them up within 21 days of being required to do so. If the nominee is acquiring existing shares in, or subscribing for a new issue of shares by, a company already formed, the directors of the company are to be liable with the nominee for the payment up (section 144(2)(b)). But if the nominee is subscribing for the initial issue of a newly formed company, the liability falls on the nominee’s fellow subscribers (section 144(2)(a)). The point in each case is that the company is not liable. These provisions follow Article 18.2 and 3 closely.

Where shares are acquired or subscribed for in an existing company, the above provisions work well enough. But in the case of a newly formed company, it will be necessary to adapt subsection (2)(a) to refer to “founder members” rather than “subscribers” and to allow for the possibility of single member public companies by imposing the liability on “other founder members, if any”.

Subsection (3). Provides that where proceedings for recovery are taken under this section against a subscriber or director, who is found to be liable, the court may relieve the liability in whole or in part if it appears that he has acted honestly and reasonably and ought to be excused. This is covered by Article 18.3. (A nominee relieved of liability under this provision would, it is thought, continue to hold the shares on his own account, though it would be open to the court to make surrender of the shares a condition of relief.)

Subsection (4). Enables a subscriber or director with reason to expect that such a claim will be made against him to apply to the court first. The court’s powers are the same as under subsection (3).

Provision on the lines of this section is needed to implement Article 18 and it is proposed to continue its application to private companies. But it is for consideration whether the retention of subsection (4) is really necessary.
Section 145: Exceptions from section 144

Subsection (1). Introduced at a late stage into the 1980 Act, provides that where shares are acquired by a nominee in receipt of financial assistance from the company, and the company has a beneficial interest in the shares, section 144(1) does not apply – ie the company retains the beneficial interest. This covers only the acquisition of existing shares, and not subscription for shares, since the latter would be prohibited by Article 18. The provision was introduced to preserve what was understood to be the existing position in such cases. The policy justification must have been that, even if the assistance was unlawful, the company and its creditors should not be denied the beneficial interest in the shares. It is for consideration whether this exception should be limited to financial assistance covered by the exceptions to section 151.

Subsection (2). Contains two further exceptions. The first covers the case where the shares are acquired by a nominee of a company when the company has no beneficial interest in those shares. This was introduced at an even later stage of the 1980 Act, to cover the case where the company is acting as a trustee investing through a nominee – eg a bank with a trustee department or any company acting as trustee for its pension scheme or employees' share scheme. The effect here is that the nominee has the legal title to the shares and that the company has powers of management including the power to pay up the shares from the trust funds. Beneficial ownership remains with the trust beneficiaries. The second exception covers transactions undertaken before 22 December 1980 and is now spent.

It is intended to retain the substance of the first of these exceptions.

Subsection (3). Reads into this section the provisions of Schedule 2.
Schedule 2: Interpretation of references to “beneficial interest”

Part I of this Schedule applies for the purposes of sections 23, 145, 146 and 148.

Paragraph 1, Subparagraph (1). Excludes from the definition of beneficial interest certain residual interests held by the company under a pension scheme or an employees’ share scheme, provided that such interests have not vested in possession. Subparagraph (2) defines a “residual interest” as a right to receive trust property in specified circumstances; where all liabilities under the scheme have been satisfied, where a beneficiary ceases to participate in the scheme, and where the trust property exceeds what is necessary to satisfy liabilities arising or expected to arise under the scheme. Subparagraph (3) defines what is a “right” and what are “liabilities” in subparagraph (2). Subparagraph (4) defines when an interest vests in possession.

Paragraph 2 deals with the application of sections 144, 145 and 146-149 to the case where shares are exempt when issued or acquired but have vested in possession before they are paid up or disposed of.

Paragraph 3 excludes from the definition of a “beneficial interest” a company’s rights of security or set-off in relation to the interests of a scheme member, for the purpose of discharging a monetary obligation due to the employer or former employer; and a right to receive reimbursement for certain payments under the Pension Schemes Act 1993.

Paragraph 4 excludes from the definition of “beneficial interest” a company’s right in its capacity as a trustee, including rights to remuneration, reimbursement of expenses or indemnification for acts or omissions in the performance of its duties as trustee.

Paragraph 5 defines “pension scheme”, “relevant benefits”, “employer” and “employee” as these terms as used in Part I the Schedule.

It is proposed to retain the substance of Schedule 2.
Section 146: Treatment of shares held by or for a public company

This section deals with the disposal of shares in itself which a company has acquired or which a third party has acquired for it, in a number of specified circumstances. The provision implements Article 20.1 and 2 of the Second Directive. (This section does not cover the case where the shares were acquired while a company was a private company, and it reregisters as a public company before the shares are disposed of or cancelled. This is dealt with in section 148.)

Subsection (1) lists the circumstances in which the operative subsections ((2) and (4)) apply. These are where:

(a) the shares are forfeited or surrendered to the company for failure to pay up a sum due in respect of them. (See section 143(3)(d) above, and Article 20.1(e) of the Directive);

(b) the company has itself acquired the shares otherwise than under any of the exceptions in section 143(3), and has a beneficial interest in them, (but the acquisition is nevertheless lawful – if it is unlawful, section 143(2) applies). This situation could arise as a result of a gift or bequest to the company;

(c) a nominee acting for the company has acquired the shares from a third person without financial assistance from the company and the company has a beneficial interest. This situation could arise as a result of a gift or bequest to the nominee; and

(d) a person has acquired the shares with financial assistance from the company and the company has a beneficial interest in the shares. In this case the financial assistance is unlawful but the acquisition is not. (The inclusion of this case here is logically required by its exclusion in section 145(1) from section 144(1); see also comment on section 145(1).)

References to “beneficial interest” are to be interpreted according to Schedule 2.
**Subsection (2).** Provides that in the above cases, unless the shares have been disposed of first, the company must:

- within the “relevant period” from the forfeiture/surrender/acquisition of the shares, cancel them and reduce the share capital by the nominal value of the shares cancelled; and
- if the result is to reduce the share capital below the authorised minimum, apply for reregistration as a private company, explaining the effect of the cancellation.

This implements Article 20.2 of the Second Directive for cases (a), (b) and (c), Article 21 for (d) and Article 20.3 for all cases. **Subsection (3)** defines the “relevant period” within which shares must be cancelled as three years for cases (a), (b) and (c), and one year for (d). These reflect the different periods in Articles 20.2 and 21 of the Second Directive respectively.

**Subsection (4).** Provides that neither the company, a nominee or another shareholder may exercise any voting rights in respect of the shares between forfeiture/surrender/acquisition and cancellation. This implements Article 22.1 of the Directive for shares temporarily held under this section.

It is proposed to retain the substance of this section. It should however be noted that Article 20.2 of the Second Directive offers a Member State option not to insist on cancellation where shares acquired under (a), (b) or (c) under subsection (1) above do not exceed 10% of subscribed capital. It was decided in 1980 not to take advantage of this option. That decision will be reviewed in the light of the Department’s decision whether, following its recent consultation, to permit shares acquired under Chapter VII to be held in treasury.
Section 147: Matters arising out of compliance with section 146(2)

Subsection (1). Provides that the company may take steps to comply with section 146(2) without going through the procedure for reducing capital (see above on sections 135 ff).

Subsections (2)-(4). Deal with the case where compliance involves reregistration of a public company as a private company (see section 146(2)(b) above). These subsections follow closely the provisions of sections 53 and 55 on the reregistration of a public company as private, and it is proposed to consider them later, as part of the review of Part II of CA1985.

Section 148: Further provisions supplementing section 146 and 147

The first three subsections of this section covers the special case where the shares were acquired while a company was a private company, and it reregisters as a public company before the shares are disposed of or cancelled.

Subsection (1). Provides that where a private company (or its nominee) acquires the company’s shares in any of the circumstances described in section 146(1)(a) – (d), and then reregisters as a public company, then, with one modification, sections 146, 147 and 149 (see below) should apply as if the company had been a public company all along.

Subsection (2). Gives the modification. The periods of three years and one year within which the shares are to be cancelled run in this case not from the date of the forfeiture/surrender/acquisition of the shares but from the date of the reregistration.

Subsection (3). Applies the provisions of Schedule 2 for the purposes of this section.

Subsection (4). Provides that where a public company or its nominee acquires the company’s own shares or an interest in such shares, and includes an amount equal to their value as an asset in the balance sheet, the company must also transfer an equivalent amount to an undistributable reserve. This implements Article 22.1(b) of the Second Directive.

It is proposed to retain the substance of this section.
Section 149: Sanctions for non-compliance

Subsection (1). Deals with failure by a public company to apply to be reregistered as a private company when required by section 146(2)(b) to do so. The company is to be subject to the ban in section 81 on offering shares or debentures to the public, but is otherwise to be treated in all respects as a public company.

Subsection (2). Provides for fines on the company and any officer in default for failure to cancel shares in accordance with section 146(2)(a) or to apply for the reregistration of the company as private under section 146(2)(b).

It is proposed to retain this provision. It is intended to retain the penalty on the officer of the company but to drop the penalty on the company itself (see note on section 143(2) above).

Section 150: Charges of public companies on their own shares

This section implements Article 24 of the Second Directive which states that acceptance of the company’s shares as security, either by the company or a person acting on its behalf, shall be treated as an acquisition.

Subsection (1). Provides that, subject to the following exceptions, a lien or other charge of a public company on its own shares is void. This subsection is subject to section 6 of the Companies Consolidation (Consequential Provisions) Act, subsection (3) of which provides in terms that a charge on its shares accepted by an “old” public company which does not apply to be reregistered as a (new) public company is not void under this section.

Subsection (2). Makes an exception for a charge which is security for an amount unpaid on partly paid shares. This reflects the view that a lien for unpaid calls is not an “acceptance of shares as security” for the purposes of Article 24.1.

Subsection (3). Makes an exception for a charge which is accepted in the ordinary course of business by a company whose ordinary business either includes the lending of money or consists (exclusively) of extending credit. This exception applies whether the shares are fully paid or not, and is covered by Article 24.2 of the Directive.
**Subsection (4).** Makes an exception for a charge on its shares accepted by a company of a type other than a public company which then becomes a public company by reregistration or by registration under section 680. The policy of preserving existing property rights is understandable; the provision is consistent with Article 24 because that refers to the acceptance of shares as security, not their retention.

This subsection does not apply in the case of an “old” public company as referred to in section 6(3) of the Consequential Provisions Act (see above).

It is proposed to retain the substance of this section. But it is for consideration whether it is still necessary to retain the transitional provision in subsection (1) for the charges etc of “old” (pre-1980) public companies.

**Sections 151-158: Financial assistance by a company for the acquisition of its own shares**

The discussion of these sections is based on paragraphs 5.4.20-25 of the Strategic Consultation Document. It is therefore assumed that for public companies the constraints of Article 23 of the Second Directive will still apply (although preliminary discussions in Brussels on the simplification of company law have revealed a widespread opinion that Article 23 should either be abolished or at least substantially modified so as to allow transactions that are economically necessary eg MBOs and LBOs); and that the limited changes suggested for public companies in the Department’s letter of 21 April 1997 will be included in the next consultation. For private companies, this analysis reflects elements both of the proposal in paragraph 5.4.24 of the Strategic Consultation Document and of the proposal in the Department’s letter referred to.

**Section 151: Financial assistance generally prohibited**

**Subsection (1).** Provides that where a person is acquiring or proposing to acquire shares in a company, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of that acquisition before or at the same time as the acquisition takes place.
This implements Article 23.1 for public companies. There is no obligation to retain any prohibition on the giving of financial assistance by other types of company.

In the course of a recent internal Departmental review it was proposed to make two changes to the scope of section 151:

a) to clarify the geographical scope of the section, which the judgement of Millett J in *Arab Bank plc v. Mercantile Holdings Ltd and another* [1994 2 AllER 74] found had been inadvertently altered by the 1985 consolidation (to overcome this, Millett J applied the presumption that in the absence of a contrary intention section 151 could not have extra-territorial effect);

it was therefore proposed to amend section 151(1) to make clear that its prohibition did not apply to the provision of financial assistance by a foreign subsidiary for the acquisition of shares in its British parent company. It was considered undesirable in principle for British company law to seek to impose restrictions on foreign corporations; and

b) to change the position as regards unlimited companies which are not covered by the Second Directive. An unlimited company was to be permitted to provide financial assistance directly or indirectly for the purpose of acquisition of shares in itself. It could also provide such assistance for the acquisition of shares in its holding company, provided that the holding company was unlimited, and there was no intermediate limited company in the chain (which would have meant that in effect the limited company was providing indirect financial assistance).

Limited companies were to continue to be prohibited from giving financial assistance for the acquisition of shares in a holding company which is unlimited.

It was also intended to make clear (as required by Article 23) that there can be a breach of the prohibition where financial assistance is given for the purpose of an envisaged acquisition of shares, but that acquisition does not take place.
It is proposed to modify the present provision in the above ways.

**Subsection (2).** Deals with the case where the acquisition comes first and the assistance afterwards, for the purpose of reducing or discharging the liability incurred by the third party in making the acquisition.

The Second Directive does not expressly require “assistance” after the event to be covered, and it is arguably preferable to focus entirely on events and intentions at the time of or before the acquisition. It is therefore proposed in relation to assistance after an acquisition, to drop the present subsection (2) and instead to prohibit a company from entering into understandings or arrangements with a third party pre-acquisition whereby the company will post-acquisition reduce or discharge a liability incurred by the third party for the purpose of the acquisition.

**Subsection (3).** Provides for fines on the company and fines or imprisonment on officers in default for breach of the section. The Department has proposed that the sanction on the company should be removed (see also comment on section 143(2)) and that the sanction should be extended to cover shadow directors. It is proposed to include these modifications in the new legislation.

In addition to this modification of the criminal sanction, the Department has proposed to provide that a transaction would not be void solely on the grounds that it constituted unlawful financial assistance. This would reverse the established position under common law and would remove one reason why banks may be reluctant to become involved in transactions which may, even remotely, constitute financial assistance. It is proposed to include this point in the new legislation.
Section 152: Definitions for this chapter

Subsection (1). Defines “financial assistance”, “distributable profits” and “distribution”.
Paragraph (a) defines “financial assistance”. (i) – (iii) cover the three forms of assistance specifically mentioned in Article 23 – advance of funds, provision of security and loan.
“Advance of funds” translates in (i) as “gift”. “Security” is elaborated in (ii) since it was considered that “security” in EU law had a much broader meaning than in UK law where it implies a loan conceding rights over property to the lender. In (iii) “loan” is elaborated to cover forms of credit with economic characteristics similar to a loan, and the assignment of an existing loan or quasi loan as well as the making of a new one.
(iv) covers any other financial assistance which reduces a company’s net assets to a material extent, or is given by a company with no net assets. It was desired as a matter of policy to cover forms of assistance not covered by the Directive – eg the provision of free information – but subject to a “de minimis” exclusion.

Paragraph (b) defines “distributable profits” as profits available for a distribution equal in value to the assistance, and covers by reference to section 276 the case where the assistance includes a non-cash asset. Paragraph (c) reads into this chapter the definition of “distribution” in section 267.

Subsection (2). Defines “net assets” as the aggregate of the company’s assets less the aggregate of its liabilities, the latter to include any provision for liabilities or charges within paragraph 89 of Schedule 4 – ie provisions reasonably necessary to cover a loss or liability likely to be incurred, or certain to be incurred but of uncertain amount. (Note: This is a slightly different, and stricter, definition of “net assets” than that in section 154(2) qv.)

Subsection (3). Is an anti-avoidance measure to prevent people working around a narrow interpretation of what constituted “incurring a liability”. It enables the question whether someone has incurred a liability to be answered by looking at his financial position before and after the relevant transaction, rather than by reference to the form or nature of the transaction itself.

It is proposed to retain the substance of subsections (1) and (2); but it is for consideration whether the rather convoluted subsection (3) in fact clarifies the Chapter in a useful way.
Section 153: Transactions not prohibited by section 151

This section provides a number of exceptions to the general prohibition on financial assistance.

Subsection (1). Provides an exception from the prohibition on financial assistance before the acquisition of shares (section 151(1)) where the following conditions are met:

a) the company’s principal purpose in giving the assistance is not to give it for the purpose of the acquisition; or the giving of assistance is an incidental part of some larger purpose of the company; and

b) the assistance is given in good faith in the interests of the company.

This provision was introduced in 1981 in an attempt to meet concerns that the earlier provision (section 54 of the 1948 Act) was unreasonably inhibiting innocent or beneficial transactions. It was considered that the wording of Article 23 of the Second Directive “the company may not advance funds ...... with a view to the acquisition of its shares ....” permitted an exception defined by reference to the company’s purpose.

The decision of the House of Lords in Brady v. Brady, discussed at length in Gower (Fifth edition, pp. 231-233) has led practitioners to conclude that a) above failed to achieve its objective. Lord Oliver in his judgement in the Brady case indicated that “purpose” was a narrower concept than “reason” or “motive”.

The Department therefore proposed the replacement of the “principal purpose” test with one of “predominant reason”, supported by a Ministerial statement explaining the intention behind the change, and this was widely supported in consultation.

However, companies do not give financial assistance for the acquisition of their shares without any ulterior purpose/reason/motive. Some such purposes etc are innocuous or even beneficial – eg to promote wider ownership of the company’s shares, or to reward a venture capitalist for undertaking a risky investment in the company. But others, eg using the company’s own funds to repay loans taken out to finance its hostile takeover, or to assist a “supporters club” to buy the company’s shares and help it to resist a takeover, are the mischiefs against which the prohibition
on financial assistance was introduced. It is unclear how any variant on the “principal purpose” test can distinguish between desirable and undesirable ulterior motives. It is therefore for consideration whether the replacement of the “principal purpose” test with one of “predominant reason” would materially reduce the extent to which the prohibition on financial assistance catches innocent transactions.

**Subsection (2).** Provides an exception in the same terms as subsection (1) but for the case where the assistance is given after the acquisition, to discharge a liability incurred for the purpose of the acquisition (ie section 151(2)). The above comments on the value of such a provision apply equally here. If it is decided to include it, it will need to be reformulated as an exemption from the prohibition on entering into an understanding with a third party before an acquisition of shares whereby the company will discharge the liability of that party subsequently (see above on section 151(2)).

**Subsection (3).** Provides a number of exceptions to cover transactions specifically provided for in or under the legislation. These are:

- **a)** a distribution of assets by way of a lawful dividend;
- **b)** a distribution in the course of winding up;
- **c)** an allotment of bonus shares;
- **d)** a reduction of capital confirmed by order of the court;
- **e)** the redemption or buy back of shares in accordance with sections 159-181;
- **f)** anything done in pursuance of a court order relating to a company’s compromise or arrangement with its members or creditors;
- **g)** anything done in pursuance of an arrangement under section 110 of the Insolvency Act; and
- **h)** anything done under an arrangement between a company and its creditors which is binding by virtue of Part I of the Insolvency Act.
These exemptions were included in case they involve a payment by the company to a third party at or about the time that he is acquiring the company’s shares, which might otherwise be regarded as financial assistance. The above list was included in the legislation in 1981 on the basis that Article 23 is not to be understood as prohibiting transactions specifically provided for elsewhere in the Second Directive or in other Directives. It is for consideration whether it is necessary to retain these as express exceptions, against the risk that they might in some circumstances be held to constitute financial assistance. (It should be noted that the exception for lawful dividend distributions may leave considerable scope for using the assets of a cash rich company to finance its takeover.)

If a list on these lines is included, it is proposed to make two minor adjustments: a) would be widened to cover all distributions permitted under Part VIII, and not merely dividends; and d) would become “a reduction of capital duly made”, in line with the above proposals on capital reduction (see on sections 135ff).

The Department has proposed to include an additional exception for lawful commissions and fees, indemnities and warranties for underwriting share issues. The Second Directive clearly envisages that shares will be issued and acquired, and costs incurred, in connection with new issues and acquisitions of shares. The Department has therefore proposed an exemption to enable companies to set up the mechanisms and infra-structure to enable them to issue or transfer shares by contracting for services (eg professional advisers, underwriters) which will facilitate the issue or transfer.

The Department has also proposed a further exemption that financial assistance by a company or its subsidiary for the purpose of a transaction by the company which is itself the subject of a specific exemption under section 153(3) or (4) (eg the purchase of a company’s own shares) is permitted, eg giving a charge to a bank to secure a borrowing of funds to be used to pay a dividend or to purchase the company’s own shares. It is proposed to include both of these further exemptions in new legislation. It is also proposed that there should be a new exception, for private companies only, for financial assistance to facilitate transfers of shares between members of a company where there is difficulty matching buyers and sellers.
Subsection (4). Provides a number of further exceptions which are expressly covered in Article 23.

Paragraph (a) provides an exception for the lending of money in the ordinary course of business by a company a part of whose business is the lending of money. This exception for banks etc is covered by Article 23.2.

Paragraph (b) provides a general exception for the provision of financial assistance for the purposes of an employee share scheme. The assistance must also be in the interests of the company. This is covered by Article 23.2. A similar exception goes back (at least) to the 1948 Act.

Paragraph (bb) this elaboration of the exception for the acquisition of shares by employees was introduced in the Financial Services Act 1986 in order to ensure that share schemes which enabled employee shareholders and their families to buy and sell their shares among themselves were covered.

The Department’s proposals include one to broaden this paragraph further by including transactions between employees or employee trusts and outside investors.

Paragraph (c) covers the making of loans by companies to enable employees (other than directors) to acquire fully paid shares in the company to be held by way of beneficial ownership. This is also covered by Article 23.2 and goes back (at least) to the 1948 Act.

Subsection (5) defines “a company in the same group” for the purposes of paragraph (bb) of subsection (4).

It is proposed to include the substance of subsections (4) and (5) in new legislation. But it is of interest that subsection (4) paragraphs (b), (bb) and (c), plus subsection (5) and the Department’s proposal to extend subsection (4)(bb), all implement the words of Article 23.2 that the prohibition on financial assistance shall not apply to “…transactions effected with a view to the acquisition of shares by or for the company’s employees or the employees of an associate company”. It is for consideration whether this elaboration of an apparently simple and straightforward Directive provision has gained more in certainty than it has lost in accessibility.
Section 154: Special restriction for public companies

Article 23.2, in providing the exceptions, discussed above, for loans made in the course of normal banking business and for assistance for employee share ownership, limits in its second sentence the extent of the assistance to profits available for distribution. But the Second Directive applies only to public companies. So there is no external constraint on how far private companies might make use of these exceptions. Hence this section implements the restriction in Article 23.2, but for public companies only.

Subsection (1). Limits the assistance which a public company may give under section 153(4) to the following cases:

- where the company has net assets which are not reduced by the giving of the assistance;
- and
- where the company has net assets which are reduced by the assistance but the assistance is provided out of distributable profits.

Subsection (2). Provides definitions. In paragraph (a), net assets are defined for the purpose of subsection (1) as the amount by which the aggregate of the company’s assets exceeds the amount of its liabilities (taking the amount of both assets and liabilities to be as stated in the company’s accounting records immediately before the assistance is given). This definition of “net assets” differs from that in section 152(2) in providing that both assets and liabilities are to be determined by reference to book values. This was chosen since Article 15 of the Second Directive permitted it and the risk of abuse with these types of assistance is small. In paragraph (b), “liabilities” are defined for the purposes of paragraph (a) as including any amount retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to its amount or timing.

It is proposed to retain the substance of this section.
Sections 155-158. Provide a “whitewash” procedure for financial assistance by private companies. The Department’s 1997 proposals, and the Review’s recent Strategic Consultation Document have slightly different suggestions for easing this regime. The Department suggested:

- assistance which does not “materially prejudice” the company (ie is provided out of distributable profits and does not reduce net assets by as much as 3%) would be permitted without restriction;
- where this test is not met, approval by special resolution would be required; and
- there would be no requirement for a solvency declaration, and no special minority protection provision (though the general provision in section 459 would be available).

The Strategic Consultation Document suggested:

- approval by ordinary resolution, but with those with an interest in the transaction disenfranchised (for discussion of who is “interested”, see below);
- requirement for a solvency declaration;
- no exclusion for assistance below a threshold of “material prejudice”;
- no requirement for “cover” by distributable profits; and
- no special minority protection.

It is now proposed that financial assistance by a private company for the acquisition of its shares, if caught by the basic prohibition (section 151), should be permitted if the following conditions are fulfilled:

- it is approved by ordinary resolution, but with those with an interest in the transaction disenfranchised; and either
  - it does not reduce net assets by more as much as 3%; or, failing that,
  - it must be paid out of distributable profits; or, failing that,
• it must be supported by a solvency statement by the directors.

There would be no special minority protection.

This will require the reorganisation and amendment of the provisions of section 155 on the following lines:

a) financial assistance by a private company for the acquisition of its shares, or of the shares of its (private) holding company, would be permitted provided that the following conditions are met (cf. section 155(1)). A private company would, as now, not be permitted to give assistance for the acquisition of shares in its private holding company if a public company is interposed between them in the hierarchy (cf. section 155(3));

b) the first condition should be that the assistance must be approved by an ordinary resolution of the company, but that no one with an interest in the transaction may vote. Those “interested” might include:

• the directors;

• any person connected with a director;

• any person to whom or for whose benefit assistance is proposed to be given, whether or not it is proposed that they should acquire shares;

• any person whom it is proposed should acquire shares, whether or not they are to receive assistance; and

• any person connected with a person in either of the last two categories.

Assistance by a wholly owned subsidiary should be exempt: there would be no disinterested shareholders. (This provision would replace the requirement in section 155(4) for a special resolution.)
Section 155(5). Provides that, where the assistance is to be given by a subsidiary for the acquisition of shares in a holding company, that holding company and any intermediate holding company (unless wholly owned) must approve the assistance. Such a requirement should be retained; approval would, as above, be by ordinary resolution of the holding company, with members of the holding company interested in the transaction disqualified from voting.

a) the second condition should be that the company should have positive net assets and that the assistance will not reduce these by more than 3%. The definition of “net assets” for this purpose should be the weaker one in section 154(2) – qv;

b) if the second condition is not fulfilled, the third condition should be that the assistance must be provided out of distributable profits (cf. section 155(2)); and

c) if neither the second or the third condition is fulfilled, the fourth and final condition should be that the directors of the company giving the assistance, and, where the shares to be acquired are those in holding company, the directors of the holding company and those of any intermediate holding company, must make a formal solvency statement. This would retain the substance of section 155(6), but the statutory declaration should be replaced by a formal statement with appropriate penalties for a false or reckless statement.

Section 156: Statutory declaration under section 155

This section makes detailed provision for the solvency declaration to be made by the directors as part of the “whitewash” procedure. The gist of the section would be retained, but with some modifications, indicated below.

Subsection (1). Provides that a declaration should include prescribed particulars of the assistance to be given, of the recipients, and of the business of the company. The first two are clearly relevant. But it is for consideration whether the third need be retained.
Subsection (2). Lays down the content of the solvency declaration. The directors must state that they have formed the opinion that, immediately following the date on which the assistance is to be given:

- there is no ground on which the company could be found at that time to be unable to pay its debts;
- (if it is intended to commence the winding up of the company within 12 months) that the company will be able to pay its debts in full within 12 months of the commencement of winding up; and
- (in any other case) that the company will be able to pay its debts as they fall due within the coming year.

It is proposed to retain these provisions.

Subsection (3). Sets out the liabilities which the directors should take into account when considering whether the company is unable to pay its debts. These are the liabilities which would be relevant to the same question under section 122 of the Insolvency Act. This appears to be a reference to section 123(2) of the Insolvency Act, ie that the amount of the liabilities shall take account of contingent and prospective liabilities. This definition differs slightly from those in sections 152(2) and 154(2)(a) but seems appropriate here.

Subsection (4). Sets out the requirements for an auditors’ report which must be annexed to the solvency declaration. The report must state that the auditors have enquired into the state of the company and are not aware of anything to indicate that the opinions expressed by the directors in the solvency declaration is unreasonable in all the circumstances.

It is for consideration whether the requirement that the solvency statement must be supported by an auditors’ report should be retained; and, if so, whether the present requirement on auditors to “enquire into the state of affairs of the company” should be replaced with narrower wording requiring them to make enquiries necessary for the (limited) purpose of vetting the solvency statement.
Subsection (5). Requires the statutory declaration and auditors’ report to be delivered to the registrar of companies:

a) together with a copy of the special resolution passed under section 155 (which must itself under section 380 be delivered to the registrar within 15 days of being passed); or

b) where there is no need for such a resolution (because the company giving the assistance is a wholly owned subsidiary) within 15 days of the making of the declaration.

Publicity requirements on these lines should be retained as essential if the procedure is to achieve its purpose of creditor protection. But the reference to a special resolution will need to be replaced by one to the new ordinary resolution with limited franchise (see on section 155(4) above); and the 15 day deadline for the delivery of the resolution will need to be expressed here, since the reference to section 380 will no longer be relevant.

Subsection (6). Provides for fines on the company and on any officer in default for failure to deliver the solvency declaration and auditors’ report to the registrar within the deadline. The penalties on an officer of the company should be retained, but those on the company itself should be dropped (see note on section 143(2) above).

Subsection (7). Provides for a fine or imprisonment on a director who makes a statutory declaration without reasonable grounds. This should be retained. (Personal liability for directors seems inappropriate here.)

Section 157: Special resolution under section 155

This section makes a number of provisions relating to the special resolution now required for the “whitewash” procedure. Some of these provisions will disappear; others should be retained in modified form.
Subsection (1). Requires that the special resolution must be passed on the same date as the solvency declaration is made or within a week afterwards. Since the solvency statement can only be made on the basis of the company’s position at a particular time, and circumstances can change quickly, it is necessary to link closely the timing of the statement and the new resolution. The substance of this provision should be retained, relating the timing of the resolution approving the assistance to that of the solvency statement.

Subsections (2) and (3). Provide for a minority of shareholders to apply to the court to cancel the resolution. It is proposed to drop these provisions. The remedy under section 459 will still be open to a dissenting minority.

Subsection (4)(a). Provides that the solvency declaration and auditors’ report must be available for inspection at the meeting at which the special resolution is passed, otherwise the resolution is ineffective. It is proposed to retain a provision on these lines, suitably modified. But this will be reviewed in the light of consideration of the law relating to company general meetings.

Subsection (4)(b), which provides that a resolution is ineffective if cancelled by the court, is consequential on subsection (2) and will disappear.

Section 158: Time for giving financial assistance under section 155

This section is included to ensure a) that the giving of financial assistance is not unduly delayed after the solvency declaration, but b) that a dissenting minority nevertheless has time to apply to the court to cancel the resolution approving the assistance. The first of these aims is still valid, but the second disappears along with section 157(2).

Subsection (1). States the purpose of the section – to provide for the time before and after which financial assistance may not be given under the “whitewash” procedure. There will be no need now to prescribe the time before which the assistance may not be given. But it is still necessary to set a limit after which the assistance may not be given. The directors cannot be allowed to carry in their pocket indefinitely a valid authority to give financial assistance, regardless of changes in the solvency of the company or the views of the members.
Subsection (2). Provides that the assistance may not be given less than four weeks after the passing of the special resolution (or the last of them if there are several). This limit does not apply if the resolution was passed unanimously. This provision will go.

Subsection (3). Provides that if an application is made to the court to cancel the resolution, the assistance may not be given before the final determination of the application unless the court decides otherwise. This will also go.

Subsection (4). Provides that the assistance may not be given after the expiry of eight weeks from the making of the statutory declaration (or the first of them if there are several) unless the court decides otherwise. A provision on these lines, appropriately modified, is needed. By relating the interval to the solvency declaration, the provision makes clear that the prime concern is that a valid and responsibly made declaration may quickly become out of date. It is necessary to tie the period to the first declaration where there are several, otherwise one holding company in a chain could delay the giving of assistance by deferring its declaration and resolution. The reference to the court now disappears. It is for consideration whether the eight week period can be reduced, now that the right of the minority to apply to the court will go.

Sections 159-181: Redeemable shares: purchase by a company of its own shares

These provisions were introduced for the first time in the 1981 Act. Until that time, a company could not acquire its own shares except in the limited circumstances set out in section 143(3) (apart from paragraph a) which refers to these sections). See discussion of section 143 above.

The one exception was redeemable preference shares, which were permitted under the 1929 Act (Gower, Sixth Edition, p.251). Articles 19-22 of the Second Directive allow Member States the option of permitting public companies to acquire their own shares, subject to certain conditions. Article 39 of the Second Directive also permits Member States to authorise public companies to issue redeemable shares.
Sections 159 and 160 lay down rules for redeemable shares – i.e., shares which by the terms of their issue are to be (or liable to be) redeemed; but by section 162(2), the same rules (with one obvious exception) apply to the purchase of own shares. In fact, the redemption of redeemable shares is most logically seen as a special case of the purchase of own shares by a company. The capital maintenance issues are essentially the same. The difference concerns the decision on the price and other terms of the repurchase. In the case of redeemable shares, these are fixed in advance, and the interests of shareholders need to be safeguarded at that time. But in the general case of purchase of own shares, the decision is taken shortly before the transaction(s) concerned. An arrangement which dealt first with the provisions common to all purchases of own shares, and then separately with the different procedures for fixing the terms of the purchase, might be more user friendly.

It should be noted that this Chapter of CA1985 is subject to amendment in the light of decisions to be taken following the Department’s Consultation Document on Share Buybacks (URN 98/713). This concerns the question whether (and under what conditions) companies should be permitted to buy back shares without cancelling them, holding them instead “in treasury” for the purpose of reselling them in the future.

Section 159: Power to issue redeemable shares

Subsection (1). Provides that, subject to the following provisions of the chapter, a company with a share capital may, if so authorised by its Articles, issue shares which are to be, or are liable to be redeemed at the option of the company or the shareholder. It appears to follow that the terms of redemption may lay down periods during which an option of redemption can be exercised; and may provide for the option to be exercisable by the company, by the shareholder, or by both.

Subsection (2). Provides that no redeemable shares may be issued where the company has no shares in issue that are not redeemable. This provision was introduced, when the power to issue redeemable shares was extended to ordinary shares, to avoid the risk that the redemption of a company’s redeemable shares would leave the company without members. This provision is complemented by section 162(3) which provides that a company may not purchase its own shares if, as a result, it would have no shares left other than redeemable shares (see below).
Subsection (3). Provides that redeemable shares may not be redeemed unless they are fully paid; and the terms of redemption must provide for payment on redemption. The first of these provisions implements Article 39(b) of the Second Directive for public companies and avoids the reduction in capital which would result if partly paid shares were redeemed in full. The second provision ensures that the consideration for redemption is actual payment, and that payment is made at the time the shares are redeemed, not advanced or delayed. This is intended to ensure appropriate accounting treatment when the shares are cancelled on redemption.

It is proposed that conditions on the lines of subsections (2) and (3) should be retained both for private and public companies.

Section 159A: Terms and manner of redemption

This section was enacted in the 1989 Act to replace section 160(3), the wording of which requires a new provision in the Articles for each new issue of redeemable shares. It was argued that this made it difficult for the directors, in deciding the terms of the issue, to respond to changes in the market. Section 159A was introduced at a late stage in the 1989 Bill, and the Minister made clear that it would only be introduced if the Government were satisfied, on a more thorough examination, that it would work. Consultation then revealed that the discretion envisaged for the directors over the timing of redemption (subsection (2)) and the amount payable on redemption (subsection (4)) still did not meet the case, and the section has therefore never been commenced. Moreover, Article 39(c) of the Second Directive provides that “the terms and manner of redemption must be laid down in the company’s statutes or instrument of incorporation”. It is not clear that section 159A would comply with this. In 1993 the Department concluded that section 159A should not be brought into force and that section 160(3)(qv) should remain operative.
Section 160: Financing of redemption

This section contains provisions to ensure that the redemption of redeemable shares cannot result in a reduction of assets represented by the company’s undistributable reserves. It implements for public companies Article 39(d) of the Second Directive. It applies, in qualified form, to private companies, but is subject in their case to a special procedure for redeeming (or purchasing) shares out of capital – see under section 171ff below.

Subsection (1). Provides:

  a) that redeemable shares may only be redeemed out of distributable profits or out of the proceeds of a fresh issue of the shares made for the purpose of the redemption. “Distributable profits” are defined in section 181 (see below); and

  b) that any premium payable on redemption must be paid out of distributable profits. (Under the previous law, a premium payable on the redemption of redeemable preference shares could be met from the share premium account.)

These provisions are subject to subsection (2) (qv), to section 171 which allows private companies, on certain conditions, to redeem or purchase shares from capital, and to section 178(4) on the terms of redemption or purchase enforceable in a winding up. These last two provisions are discussed below.

It is proposed to retain the substance of this provision for public companies if par values remain for them. For private companies, and for public companies if par values go, it will be sufficient to provide that shares may be redeemed from the proceeds of a new issue of shares, failing which they must be redeemed from distributable profits.

Subsection (2). Modifies and relaxes paragraph (b) of subsection (1). Where redeemable shares are issued at a premium, and redemption is achieved by a new issue of shares, the premium (as well as the nominal value) may be met from the proceeds of the new issue up to an amount equal to the lesser of:
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a) the aggregate of the premiums received on the issue of the shares now redeemed; or

b) the current amount of the share premium account (including any sum transferred to that account in respect of premiums on the new shares).

Where advantage is taken of this subsection, the share premium account is to be reduced by the amount of any payment made by virtue of this subsection out of the proceeds of the new shares. This complicated provision avoids a situation where the redemption by a new share issue of redeemable shares originally issued at a premium results in a forced increase in the share premium account, but it still guards against a reduction of the capital yardstick. The subsection implements for public companies Article 39(g) of the Second Directive – apparently the only reference in the Directive to the share premium account. A provision on these lines should be retained for public companies.

Subsection (3). Remains in force since section 159A has not been commenced. The subsection provides that, subject to the following provisions of the Chapter, redemption of redeemable shares may be effected on such terms and in such manner as may be provided in the company’s Articles. This wording follows closely that of Article 39(c) of the Second Directive, and should be retained for public companies. It is for consideration whether it should cease to apply to private companies, who would thus be free to delegate to the directors decisions on the terms and manner of redemption applying to redeemable shares both at the time of issue, and subsequently if circumstances changed.

Subsection (4). Provides that redeemable shares redeemed under this section shall be treated as cancelled and the nominal value of the issued share capital diminished accordingly. But the authorised share capital is not reduced.
This provision states what is perhaps obvious, namely that the redemption of a redeemable share logically implies its cancellation. This is also the unstated assumption of Article 39(e) of the Second Directive, which provides for the creation of a balancing capital reserve in order to compensate for such cancellation. It follows that the company’s share capital will be diminished accordingly. But if, as is proposed, authorised share capital is abolished, the reference to authorised share capital will disappear. To the extent that par values are also abolished, there will be no need to reduce the single subscribed share capital account as a result of a redemption or repurchase (assuming that redemption or repurchase is not out of capital).

Subsection (5). Provides that any temporary excess of issued over authorised share capital resulting when a company has issued new shares to pay for the redemption of old ones should be disregarded. This will also be redundant if authorised share capital is abolished.

(Section 161 has been repealed)

Section 162: Power of company to purchase own shares

Subsection (1). Provides that, subject to the following provisions of the Chapter, a company with a share capital may, if authorised to do so by its Articles, purchase its own shares (including redeemable shares).

Subsection (2). Applies sections 159-161 – ie now just sections 159 and 160 – to the purchase of own shares as they apply to the redemption of redeemable shares, except that the terms and manner of redemption need not, in the case of the former, be determined by the Articles. The decision on the terms and manner of the purchase of own shares is subject to the more elaborate safeguards in sections 163-167 – see below. (NB: The application of this subsection to section 160(4) is subject to modification in the light of the Department’s proposals to permit repurchased shares to be held in treasury.)

Subsection (3). Provides that a company may not purchase its own shares if, as a result, it would have no shares left other than redeemable shares. This is to avoid the possibility of the company being left without shares and thus without members. (See also on section 159(2) above.)
This is the main enabling provision covering the purchase of own shares including redeemable shares (in advance of redemption). It applies to the purchase of own shares those of the provisions on the redemption of redeemable shares which are relevant. It is proposed to retain the substance of the section.

**Section 163: Definitions of “off market” and “market” purchase**

Sections 164 and 166 provide different procedures for the grant of authority to the directors for the company to purchase its own shares, depending on whether the purchase is an “off market” or a “market” purchase. Hence the need to define the two terms.

**Subsection (1).** Defines a purchase as an “off market” purchase if either a) the shares are purchased otherwise than on a recognised investment exchange, or b) the shares are purchased on a recognised investment exchange but are not subject to a “marketing arrangement”.

**Subsection (2).** Defines what is meant by “subject to a market arrangement”. This means either:

a) that the shares are listed; or

b) that the company has been offered dealing facilities without prior permission for individual transactions and without limit of time.

**Subsection (3).** Defines as a market purchase a purchase made on a recognised investment exchange and not categorised as “off market” by virtue of subsection (1)(b).

**Subsection (4).** Defines a “recognised investment exchange” as a recognised investment exchange other than an overseas investment exchange as defined in the Financial Services Act.

Provision on these lines is needed if the requirements for authority for “off market” and “market” purchases are to remain different. It is therefore proposed to retain the substance of this section. (The definition of a “recognised investment exchange” may need to reflect the terms of a new Financial Services and Markets Act.)
Section 164: Authority for off market purchase

The controls here are particularly strict since the market cannot provide an independent check on the fairness of the price at which the shares are bought.

Subsection (1). Provides that the purchase contract must be approved in advance in accordance with this and the following section.

Subsection (2). Provides that the terms of the proposed contract must be approved by special resolution before it is entered into.

Subsection (3). Provides that the authority may be varied, revoked or renewed from time to time, subject in the case of public companies to subsection (4).

Subsection (4). This provides for a public company that the authority conferred by the resolution must contain an expiry date not more than 18 months ahead. (This provision is necessary for public companies to comply with Article 19.1(a) of the Second Directive. It was decided not to extend it to private companies.)

Subsection (5). Provides that a resolution authorising an off market purchase is not effective if any member holding shares to which the resolution relates votes those shares, and the resolution would not have passed otherwise. (Such a member can however vote any other shares he holds.) This applies whether the vote is on a poll or not. Any member may demand a poll on the resolution – ie the normal thresholds do not apply. In each of these two cases, a vote or a demand for a poll from a proxy counts as one from a member.

Subsection (6). Provides that the resolution is not effective unless a copy of the contract or a memorandum of its terms is available for inspection from not less than 15 days before the meeting and at the meeting itself. A memorandum, or the contract or an annex to the contract, must include the names of all the members holding shares to which the contract relates.
Subsection (7). Provides that once a contract is approved as above, the company may agree a variation. If so, a further special resolution is required and the requirements of subsections (3)-(6) must again be met. Both the original contract and the variation, or a memorandum of each, must be made available in accordance with subsection (6).

These onerous requirements seem justified, both for public and private companies, in view of the possibilities for abuse. It is therefore proposed to retain the substance of the section. (The procedural provisions in subsections (5) and (6) may need to be reviewed in the light of further work on the law relating to company general meetings.)

Section 165: Authority for contingent purchase contract

Subsection (1). Provides that a company may purchase what is in effect either a forward obligation or an option to purchase its shares at a later date.

Subsection (2). Provides that in such a case the company may only purchase its own shares in accordance with such a contract if the contract is approved in advance by special resolution and section 164(3)-(7) complied with. This rules out market purchases of derivative contracts related to the purchase of the company’s shares, since it would be impracticable to approve the terms in advance. This was deliberate. It was thought undesirable to permit the company to speculate in its own shares. It is proposed to retain the substance of the section.

Section 166: Authority for market purchase

The requirements in this section are less strict than those in section 164, since there are not the same risks of collusion with a known seller to arrange a purchase at an artificial price.

The requirements broadly follow, and implement for public companies, those in Article 19.1(a) of the Second Directive.

Subsection (1). Requires prior authority for any market purchase by the company in general meeting, the first point in Article 19.1(a). An ordinary resolution suffices. The disenfranchisement of the vendor, and the advance disclosure of the contract, are not relevant to a market purchase.
Subsection (2). Provides that the authority given under subsection (1) may be general or limited to purchases of shares of a particular class or description, and may be conditional or unconditional. Thus there is no need for separate authority for each purchase.

Subsection (3). Implements 3 specific requirements of Article 19.1(a). The authority must:

- specify the maximum number of shares authorised to be acquired;
- determine the maximum and minimum prices which may be made; and
- specify an expiry date for the authority.

Subsection (4). Provides that the authority may be varied, renewed or revoked by the company in general meeting, subject to subsection (3); and that in a resolution to confer or renew authority the expiry date set must be no more than 18 months after the passing of the resolution. (The 18 month limit is also included to implement a requirement of Article 19.1(a).)

Subsection (5). Provides that a company may make a market purchase after the expiry date set in the resolution granting the authority provided that the contract of purchase was concluded within the time limit and the terms or the authority contemplated execution after its expiry. (The recent reductions in settlement periods have reduced the significance of this provision.)

Subsection (6). Provides that the authority may specify the maximum and minimum prices as required by subsection (3) either by specifying a particular sum or by providing a formula for calculating the price. Such a formula may not include a reference to any person’s discretion or opinion.

Subsection (7). Provides that a resolution under this section must be sent to the registrar under section 380. (Express provision for this is needed since the resolution is an ordinary one. A special resolution under section 164 or 165 is covered by section 380 anyway.)

It is proposed to retain these provisions for all companies, but in practice they will be relevant only to public companies.
Section 167: Assignment or release of company’s right to purchase own shares

Subsection (1). Provides that the rights of a company under a contract approved under section 164 or 165, or authorised under section 166, are not capable of being assigned. This was thought necessary to stop a company speculating in its own shares or trying to rig the market. (An assignment, at a low price, of rights to purchase may be caught as financial assistance. But the main reason for keeping this provision is that without it the shareholders may find that they have approved the purchase on a false assumption.)

Subsection (2). Provides that an agreement to release its rights under a contract under section 164 or 165 is void unless the terms of the release have been approved in advance by special resolution. Subsections 164(3)-(7) apply as for a variation of an existing agreement. This is to cover the case where an agreement is approved for the purchase of shares from eg a director, and the price then moves against the vendor.

It is proposed to retain the substance of this section.

Section 168: Payment apart from purchase price to be made out of distributable profits

The payment of the purchase price must be made either from distributable profits or from the proceeds of a new issue of shares made for the purpose (section 160(1), applied by section 162(2)). This section deals with other payments related to a purchase of own shares.

Subsection (1). Provides that payments made in consideration of any of the following must be made from distributable profits (defined in section 181):

- acquiring a right to purchase, in pursuance of a contract approved under section 165;
- the variation of a contract approved under section 164 or 165; and
- the release of the company’s obligations under a contract covered by section 164, 165 or 166.
The alternative of payment from the proceeds of a new issue is not relevant to the second and third of these cases. There may be a theoretical argument for allowing it in the first case, but it would probably not be worth the resulting complexity.

Subsection (2). Provides for the consequences where payments are made under section (1) which are not made out of distributable profits. In the first case, no purchase of shares in pursuance of the contract to acquire rights is lawful under this Chapter; in the second, no purchase following the variation is lawful under this Chapter; and in the third case the purported release is void. The effect of this subsection is to treat a subsequent purchase as unlawful where the relevant payment is not covered by distributable profits. Thus the purchase is contrary to section 143(1) and not rendered lawful by section 143(3)(a), since it is not “in accordance with Chapter VII”. The penalties in section 143(2) will apply. The same applies for any purchase or redemption of shares other than from distributable profits, ie contrary to section 160(1).

It is proposed to retain the substance of this section for private and public companies.

Section 169: Disclosure by company of purchase of own shares

Article 22.2 of the Second Directive requires information on purchases of own shares to be given in the annual report of a public company. This is implemented by paragraphs 7 and 8 in Part II of Schedule 7 to the 1985 Act dealing with matters to be included in the directors’ report. (This applies to private companies as well as public, though the Directive applies only to the latter.) Section 169 requires, in addition, that documents be delivered to the registrar within 28 days of the day on which shares purchased by the company are delivered to it. The argument was that since the purchase of shares involves their cancellation, this should be disclosed on the register no less promptly than the allotment of shares (section 88). In the case of redemptions, Article 39(h) requires publication of notice in accordance with the First Directive. This is implemented by section 122(1)(e) combined with section 711(1)(h).

Subsection (1). Provides that within 28 days of the delivery to the company of share purchase by it the company shall deliver to the registrar a return stating the number and nominal value of shares of each class delivered to it and the date on which they were delivered.
**Subsection (2).** Provides, in the case of public companies only, that the return shall also state the aggregate amount paid for the shares and the maximum and minimum price paid for shares in each class purchased.

**Subsection (3).** Provides that details of shares delivered on different dates and under different contracts may be included in a single return.

**Subsection (4).** Requires the company to keep at its registered office a copy of a contract authorised or approved under section 164, 165 or 166, or a memorandum of its terms. This must be kept for 10 years from the completion of the last purchase or the determination of the contract, whichever is later.

**Subsection (5).** Requires that a copy of the contract or memorandum must be available for inspection free of charge, in the case of a private company by a member and in the case of a public company by anyone.

**Subsection (6).** Provides for fines on any officer in default for failure to deliver documents to the registrar on time under the section. There is no penalty for the company.

**Subsection (7).** Provides for fines on the company and an officer in default for contravention of subsection (4) or (5).

**Subsection (8).** Provides that the court may order an immediate inspection under subsection (5).

**Subsection (9).** Provides that the obligation under subsection (4) to keep a copy of the contract or agreement applies also to any variation, as long as the variation applies to the contract.

Given that the relevant disclosure provisions in the Second and Fourth Directives are implemented elsewhere in the legislation, there is a case for dropping the requirements of section 169, certainly for private companies and also arguably for public companies. The point will be considered in the work of the Review on the law relating to the disclosure of information at Companies House and at the company’s own offices.
Section 170: The capital redemption reserve

The purpose of this section is to ensure that where payment for own shares purchased or redeemed is made wholly or partly out of profits, the reduction in issued share capital is not matched by a reduction in capital as represented by undistributable reserves.

Subsection (1). Provides that where shares are redeemed or purchased wholly out of profits, the amount by which the share capital is diminished on cancellation of the shares is to be transferred into a “capital redemption reserve”. In the case of public companies, and for redemptions only, this implements Article 39(e) of the Second Directive. (In the case of share purchases, the view was presumably taken that the same requirement applies by analogy, although in this case the Directive does not expressly provide for the cancellation of shares or the creation of a balancing reserve.)

Subsection (2). Provides that where shares are redeemed or repurchased wholly or partly out of the proceeds of a new issue, and the aggregate amount of those proceeds is less than the nominal value of the shares redeemed or repurchased, the amount of the difference shall be transferred to the capital redemption reserve.

Subsection (3). Provides that subsection (2) does not apply if the proceeds of the new issue are applied by the (private) company, in addition to a payment out of capital, in making a redemption or purchase out of capital under section 171. In that case, at present the rules in section 171(4) – (6) apply.

Subsection (4). Provides that the capital reduction provisions of the Act apply to the capital redemption reserve as if it were paid up share capital, except that it may be used in paying up bonus shares.

In the case of public companies, Article 19.1(c) of the Second Directive, read with Article 15.1(a), requires that purchases of own shares do not reduce net assets below the level of the undistributable reserves representing the capital yardstick (and a similar requirement applies in the case of redemptions, by virtue of Article 39(d)). It must follow that a purchase of own shares cannot be accompanied by a reduction of that yardstick (and similarly for a redemption).
can be achieved either by holding the repurchased shares “in treasury”, in which case the share capital is undiminished, or by cancelling them and creating a new reserve equal to the nominal value of the shares cancelled. In the case of redemptions, Article 39(e) contemplates the latter. As mentioned above, Article 19, on acquisitions of shares, does not deal expressly with the question. (It is to be noted that the requirement for a new reserve in Article 22.1(b) relates only to the special circumstances where “shares are included among the assets shown in the balance sheet”.) The guiding thread of these provisions is that, except where a redemption or purchase is made out of capital, the result of the operation must be strictly neutral in capital maintenance terms. The practical question is whether, where the shares are cancelled rather than held in treasury, the maintenance of the level of the capital yardstick requires the creation of a separate capital redemption reserve. To the extent that par values are abolished, this will clearly be unnecessary. If par values are retained for public companies, the share premium account will still exist separately from share capital; it would be simplest to retain the substance of the present provision for a separate capital redemption reserve.

For private companies, and for public companies if par values go, it would appear to be sufficient to ensure that the cancellation of shares on redemption or repurchase does not lead to a reduction of subscribed share capital. (If, following a change in the law, shares are held in treasury after buyback, no question of reduction of subscribed capital will arise.)

If, as proposed, sections 171 – 177 are dropped (see below), subsection (3) will no longer have any application. The equivalent situation will be one in which the share repurchase or redemption takes place partly out of the proceeds of a new issue and partly by way of a capital reduction. The net effect on the subscribed share capital of the company concerned of the new issue and the capital reduction will be whatever it is; there will be no need for a special provision.

The substance of subsection (4), which provides that for the purpose of the provisions on capital reduction, the capital redemption reserve counts as paid up share capital, except that it may be applied in paying up shares allotted as fully paid bonus shares, should be retained for public companies.
Sections 171-177. Relax for private companies the rule that shares may only be redeemed or purchased out of distributable profits. A private company may redeem or purchase shares out of capital provided that a) any distributable profits and any proceeds of a new issue are used up first, before any payment is charged to capital (sections 171-172) and b) that a special resolution is passed, to which provision are attached publicity requirements and a right of creditors or members to object to the court (sections 174-177).

These sections were introduced in 1981 to provide a means for private companies to redeem or purchase shares out of capital without having to go through the full and compulsory court procedure for a capital reduction. However, it is now proposed to replace this procedure with a less onerous one involving a solvency statement (all companies) and a right of creditors to object (public companies only) (see on sections 136-138 above). This provides a less onerous procedure for capital reduction by private companies generally than do sections 171-177 for redemption and purchase of own shares. This indicates that provisions on the lines of sections 171-177 could be omitted from the new legislation.

Section 178: Effect of company’s failure to redeem or purchase

This section deals with the rights of the shareholder if the company fails to honour a contract to purchase his shares, or to redeem his shares in accordance with the terms of redemption.

Subsection (1). Indicates the scope of the section. It has effect where a company has issued redeemable shares or has agreed to purchase any of its own shares.

Subsection (2). Provides that the company is not liable for damages for failure to redeem or purchase its shares. Damages would leave the shareholders with the shares and might have to be paid out of capital.

Subsection (3). Provides that the shareholder retains the right to sue the company for remedies other than damages; but that the court may not order specific performance of the terms of purchase or redemption if the company shows that the costs cannot be met out of distributable profits.
This confirms by implication that specific performance may be an appropriate remedy where there are distributable profits. Gower suggests (Sixth Edition, p.263) that other remedies might include an injunction to restrain a distribution of profits which would make it unlawful to honour an obligation to redeem or purchase the shares.

**Subsection (4).** Provides that where a company is wound up, and at the commencement of winding up there are redeemable shares outstanding, or the company has agreed to repurchase shares, the terms of purchase or redemption may be enforced against the company. Where shares are redeemed or purchased under this section, they are cancelled. This is however subject to subsection (5).

**Subsection (5).** Qualifies subsection (4) by providing that it does not apply:

- a) when the terms of redemption, or purchase contract, provide for the redemption or purchase to take place after the commencement of the winding up. (In this case, the shareholder has no more rights than any other shareholder of the same class); and

- b) if the company could not lawfully have made a distribution equal to the redemption or purchase price at any time between the date on which the redemption or purchase was to have taken place and the commencement of winding up. Note that this is an elaboration of the simple rule in section 160(1) that redemption (or purchase) must be made from distributable profits (i.e. presumably those available at the redemption or purchase date).

**Subsection (6).** Deals with the priority enjoyed in the winding up by a shareholder enforcing the terms of redemption or purchase under subsection (4). The shareholder ranks after all creditors (except members in their character as such) and after other shareholders whose shares carry rights preferred to any rights of the shareholder enforcing a claim under subsection (4); but before the rights of any other members.

It is proposed to retain provision broadly on these lines.
Section 179: Power of the Secretary of State to modify this Chapter

This section includes extensive powers for the Secretary of State to modify key features of Chapter VII of Part V by regulation, subject to affirmative resolution. It is proposed to examine this and other similar powers in the light of the response to the proposals on continuing reform in the Strategic Consultation Document.

Section 180: Transitional cases arising under this Chapter and savings

This section covers matters arising from the transition from section 58 of the 1948 Act, which provided for redeemable preference shares (only), to the new provisions in this Chapter. It is for consideration whether it is necessary to retain this transitional provision, to cover any capital redemption reserves established for the purposes of section 58 of the 1948 Act and still in existence.

Section 181: Definitions for Chapter VII

Paragraph (a) defines “distributable profits” as profits out of which the company could lawfully have made a distribution equal to the payment. “Distribution” is defined in section 263(2) and distributable profits are those from which a distribution can be made without either exceeding “accumulated realised profits” as defined in section 263(3) or – in the case of public companies only – contravening the “net assets” test in section 264(1). It is proposed to retain such a definition.

Paragraph (b) defines “permissible capital payment” as the payment permitted by section 171. Since it is proposed to drop that section, the provision will fall. So will the final words of section 181 which provide that references to payment out of capital are to be construed in accordance with section 171.
Sections 263-281: Distribution of profits and assets

These sections make up Part VIII of the 1985 Act and deal with the rules governing distributions by companies to their members. The most common form of distribution to which this Part relates is the regular dividend paid by companies. The main principles of the legislation are that distributions may only be made out of distributable profits, and in the case of public companies that they may not reduce share capital and undistributable reserves.

Sections 263 and 264 contain provisions introduced in 1980 to clarify in a restrictive sense the law on this topic. They implement Article 15.1 of the Second Directive for public companies, and introduce restrictions recommended by the Jenkins Committee to apply to all companies. (It should also be noted that to remove private companies from the ambit of the distribution rules would not be compatible with the Fourth EU Company Law Directive.)

Section 263: Certain distributions prohibited

Subsection (1). States the general principle that a company may not make a distribution except out of profits available for the purpose. In the case of public companies, it implements Article 15.1(c) of the Second Directive as it applies to the distributions covered by Part VIII.

(Had the only concern been to implement Article 15, the provisions of section 264, restricting the distributions of a public company by reference to the company’s assets, would have sufficed on its own, since any distribution caught by the net assets test in that section is necessarily caught by the test of accumulated realised profits in this section. However, it was decided to implement the restrictions recommended by Jenkins for private companies as well as public. There is one situation where section 263 permits a distribution where section 264 does not – where a company has accumulated unrealised losses in excess of accumulated unrealised profits. In the case of public companies only this excess must be covered by realised profits. Given the very low capitalisation of many private companies, the extra safeguard for creditors offered by the net assets test does not appear to be worth the added burden on the companies.)
Subsection (2). Defines, by exclusion, the distributions to which Part VIII applies. Those excluded are distributions by way of:

- an issue of fully or partly paid bonus shares;
- a redemption or purchase of the company’s shares out of capital or out of unrealised profits in accordance with Chapter VII of Part V (see above). N.B: This means that payments by way of redemption or purchase of own shares are nevertheless distributions for the purpose of Part VIII if they are made out of realised profits;
- a (formal) reduction of share capital, whether by paying off paid up shares or extinguishing or reducing the liability on partly paid shares; and
- a distribution by a company to members on winding up and distributions in cash or non-cash assets are both covered.

Subsection (3). Seeks to define what are “profits available for distribution”. They are “accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less .... accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made”. Under section 262(3), “realised” profits and losses are those treated as such in accordance with accounting principles, including accounting standards generally accepted at the time the accounts are prepared – wording in which Gower finds “a note of frustrated desperation” (5th edition, p.245)! Furthermore, UK GAAP must take into account European law on what constitutes a realised profit (eg the ECJ case Waltraud Tomberger v Gebruder v.d. Wettern GmbH Case C-234/94 ).

This subsection is subject in the case of investment companies to sections 265 and 266.

Two significant changes were made when this definition was introduced in 1981. First, it prohibited “nimble dividends” – dividends paid out of the profit for the year, even though there were accumulated losses from earlier years. The exclusion from the equation of both profits and losses once they are recognised by an increase or decrease of share capital achieved in accordance with relevant procedures is logical. There are continuing problems about what should count as “realised” profits and losses, which will be examined by the Review in the general
context of the law on company accounts. Provisionally, and subject to that examination, the concept might be retained here. The second consequence of the new definition was that unrealised profits were no longer distributable except in very specific circumstances.

**Subsection (4).** Provides that a company shall not apply an unrealised profit in paying up debentures or any amounts unpaid on its shares. This prevents a company in difficulties from favouring its debenture holders or shareholders.

**Subsection (5).** Is a transitional provision to deal with the case where directors found it impossible to discover whether a profit made before 22 December 1980 was “realised”. In its present form it is spent. Transitional provisions to cover changes from the present to the new law will be considered later in the Review.

Subject to the above points on subsections (3) and (5), it is proposed to retain the substance of this section. But it is also proposed that the legislation should make clear a) that the distribution rules apply only to distributions to members in their capacity as members, and b) that the distribution rules have effect in place of any rule of law prohibiting distribution as such, but without prejudice to the general fiduciary duties and duties of skill and care, as well as to provisions in an enactment or in the company’s constitution.

**Section 264: Restriction on distribution of assets**

This section applies to public companies only and implements Article 15.1(a) of the Second Directive as it applies to the distributions covered by Part VIII. (It also, and incidentally, covers Article 15.1(c) – see above, on section 263.)

**Subsection (1).** Contains the basic provision that a public company may only make a distribution if at that time the amount of its net assets is not less than the aggregate of its called up capital and undistributable reserves, and if and to the extent that the distribution does not reduce net assets below that aggregate.

This subsection is subject in the case of investment companies to sections 265 and 266.
Subsection (2). Defines “net assets” as the aggregate of the company’s assets, less the aggregate of its liabilities – the latter to include any provision for liabilities or charges within paragraph 89 of Schedule 4 – i.e. “any amount retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise”. (This is the same test as in section 152(2) as distinct from the less stringent test in section 154(2)(a) where the amount of assets and liabilities are assessed at book value.)

Subsection (3). Defines “undistributable reserves” as:

- the share premium account;
- the capital redemption reserve;
- the excess of accumulated unrealised profits not previously utilised by capitalisation over accumulated unrealised losses not previously written off in a reduction or reorganisation of capital; and
- any other reserve which the company is prohibited from distributing by any enactment (other than Part VIII) or by its Memorandum or Articles.

The list of separate reserves would need to be amended if par values disappeared for public companies and the share premium account and capital redemption account lost their separate identity. The reference to the Memorandum or Articles will be in any case be replaced by a reference to the company’s constitution in consequence of the proposed reforms on company formation.

Subsection (4). Provides that a public company shall not include any uncalled share capital as an asset in any accounts relevant for purposes of this section. Article 15.1(b) provides that “where the uncalled part of the subscribed capital is not included in the assets shown in the balance sheet, this amount shall be deducted from the amount of the subscribed capital referred to in paragraph (a)”. This assumes an accounting practice whereby uncalled capital is included in the balance sheet as an asset, and also as part of the subscribed capital on the liabilities side. Article 15.1(b) then provides an exception for jurisdictions, including the UK, where it is not the
practice to include uncalled share capital as a balance sheet asset. This subsection, together with
the balance sheet formats in Schedule 4 to the Act, implement Article 15.1(b) by ensuring that
uncalled share capital is excluded from both sides of the balance sheet.

Subject to the comment on subsection (3) above, it is proposed to retain the substance of this section.

**Section 265: Other distributions by investment companies**

This section takes advantage of the Member State option provided by Article 15.4 of the Second
Directive to relax the provisions of sections 263 and 264 in favour of investment companies.
Without these relaxations, an investment company the value of whose investments had fallen –
perhaps as a result of general trends in the stock market – would be unable to pass on to
investors any of the dividend income from the investment company’s own investments. Failure to
pass on dividend income would in turn result in the loss of tax privileges enjoyed by investment
companies. Investment companies are defined for this purpose in section 266 (see below).

**Subsection (1).** Provides that, in addition to distributions permitted under sections 263 and 264,
an investment company may also make a distribution at any time out of its accumulated, realised
revenue profits, so far as not previously utilised by a distribution or capitalisation, less its
accumulated revenue losses (whether realised or unrealised) so far as not previously written off
in a capital reduction or reorganisation. This facility is however only available if at the time of
the distribution the amount of the investment company’s assets is at least equal to one and a half
times its liabilities (a Directive requirement); and if the distribution does not itself reduce the
assets below that level. The subsection is also subject to the following subsections.

The relaxation permitted by Article 15.4 is not limited to revenue profits, and in March 1999 the
Department published for consultation a proposal the effect of which would be to permit an
investment company to use capital profits for the sole purpose of a share buyback under Chapter
VII of Part V of the Act, without this affecting the company’s freedom to distribute revenue
profits. The purpose of this change would be to enable investment companies to buy back their
shares as a means or reducing or eliminating the discount to net asset value at which their shares
are trading. The Department is currently considering the responses received.
Subsection (2). Defines liabilities as including any provision for liabilities or charges within paragraph 89 of Schedule 4.

Subsection (3). Provides that the company shall not include any uncalled share capital as an asset in any accounts relevant for purposes of this section. (See comment on section 264(4) above.)

Subsection (4). Restricts the circumstances in which an investment company may use the facility offered by the section. The conditions are:

a) the company must be listed on a recognised investment exchange other than an overseas investment exchange as defined in the Financial Services Act; and

b) during the relevant period it has not:

i) distributed any of its capital profits;

ii) applied any unrealised profits or any capital profits (realised or unrealised) in paying up debentures or amounts unpaid on its issued shares.

If the Department’s recent proposal is accepted, i) will refer to the distribution of capital profits other than by way of a share buyback under Chapter VII of Part V.

Subsection (5). Defines the relevant period for the purpose of subsection (4). This period begins with the first day of the accounting period immediately before that in which the distribution is to be made; where the distribution is to be made in the company’s first accounting period, the relevant period begins at the first day of that accounting period. The “relevant period” ends with the date of the distribution.
Subsection (6). Provides that a company may only make a distribution by virtue of subsection (1) if it has given notice in the prescribed form to the registrar of the company’s intention to carry on business as an investment company before the beginning of the relevant period. (There is also a transitional provision for companies incorporated on or after 22 December 1980.)

Investment companies thus do not need to be accepted as such under the companies legislation; they select themselves, and are responsible for continuing to meet the requirements in section 266.

It is suggested that a provision on the lines of this section be retained, with any change as a result of the Department’s recent proposals. (The position of any companies which took advantage of the transitional provision will need to be preserved.)

Section 266: Meaning of “investment company”

Subsection (1). Provides that an investment company is a company which has given notice to the registrar under section 265(6) above (which has not been revoked) and which has from the date of the notice complied with the following requirements.

Subsection (2). Sets out a number of detailed requirements. These are:

a) that the business of the company consists of investing its funds mainly in securities, with the aim of spreading investment risk and giving members of the company the benefit of the results of the management of its funds;

b) that none of the company’s holdings in companies (other than in other investment companies) represents more than 15% of the company’s investments;

c) that distribution of the company’s capital profits is prohibited by its Memorandum or Articles;
(the reference to the Memorandum and Articles will be replaced by one to the company’s constitution in consequence of the proposals on company formation; and acceptance of the Department’s recent proposal will involve an amendment to the effect that distribution of capital profits other than by way of share redemption or purchase must be prohibited); and d) that the company has not retained, otherwise than in compliance with this Part, more than 15% of the income it derives from securities in respect of any accounting period.

Some of these correspond to the conditions which a company must meet to qualify for tax concessions enjoyed by investment companies.

Subsection (3). Provides for a company to cease being an investment company on revoking the notice at subsection (1) by giving the registrar notice in the prescribed form that it no longer wishes to be an investment company.

Subsection (4). Applies relevant provisions of the tax legislation for the purposes of section (2)(b).

Subject to the comment on subsection (2), it is proposed to retain the substance of this section.

Section 267: Extension of sections 265, 266 to other companies

This section provides a power to extend the provisions of sections 265 and 266 to investment companies investing in securities, land or other assets with the aim of spreading investment risk and giving members of the company the benefit of the results of the management of its funds. The power is exercisable by affirmative resolution procedure. The power has not been used, although draft Regulations were prepared in 1997 to extend the provisions to housing investment trusts – in the event they were never made. It is proposed to examine this and similar powers in the light of the response to the proposals on continuing reform in the Strategic Consultation Document.
Section 268: Realised profits of insurance company with long term business

This section adapts the definitions of a “realised profit” and a “realised loss” as applied to insurance companies with long term business, to take account of the special accounting regime to which such companies are subject.

Subsection (1). Provides that where an insurance company covered by Part II of the Insurance Companies Act 1982 carries on long term business:

a) any amount included in the relevant part of the company’s balance sheet which represents a surplus in the funds maintained in respect of the long term business and which has neither been allocated to policy holders nor carried forward unappropriated is to be treated as a realised profit for the purposes of this Part; and

b) any deficit in the same fund or funds is to be treated as a realised loss for the purposes of this Part.

Otherwise any profit or loss arising in long term business is to be left out of account for those purposes.

Subsection (2). Contains definitions for the purposes of subsection (1).

Paragraph (aa) defines the “relevant part” of the balance sheet by reference to Schedule 9A of the Act, which sets out the requirements for the accounts of insurance companies. Paragraph (a) defines a “surplus” in a “fund” as an excess of assets over liabilities attributable to long term business, as shown by actuarial investigation. Paragraph (b) defines a “deficit” in a “fund” as an excess of liabilities over assets as so shown.

Subsection (3). Provides definitions of “actuarial investigation” and “long term business” by reference to relevant provisions of insurance legislation.

Subject to consultation with the authorities responsible for the regulation of insurance companies, it is intended to retain a provision on the lines of this section.
Section 269: Treatment of development costs

The purpose of this section is to implement Article 34 of the Fourth Company Law Directive as it applies to the accounting treatment of development costs, and at the same time to take advantage of the Member State option in Article 37.1 of the Directive to enable a company to derogate from Article 34 in exceptional circumstances.

Subsection (1). Provides that where development costs are shown as an asset in a company’s accounts, any amount shown in respect of those costs is to be treated under section 263 as a realised loss and under section 265 as a realised revenue loss.

This implements for development costs Article 34.1(b) of the Fourth Directive, which provides that where formation expenses (which include development costs) are not completely written off, no distribution shall take place unless the amount of the revenue available for distribution and profits carried forward, are at least equal to that of the expenses not written off.

Subsection (2). Implements Article 37.1 of the Directive by providing that subsection (1) does not apply to any part of the amount there referred to which represents an unrealised profit on revaluation of the costs. Nor does it apply if there are special circumstances justifying the directors in deciding that the amount is not to be treated as in subsection (1) and a note to the accounts explains the circumstances justifying the directors’ decision, as required by the accounting rules in Schedules 4 (Form and Content of Accounts) and 8 (Form and Content of Accounts prepared by Small Companies).

This provision will be considered by the Review in the general context of the law on company accounts. For present purposes, it should be assumed that a provision on these lines will be retained.
Section 270: Distribution to be justified by reference to a company’s accounts

Subsection (1). Is introductory: sections 270-276 are for determining whether a company may make a distribution without contravening sections 263, 264 or 265. These provisions too will be considered by the Review in the general context of the law on company accounts.

Subsection (2). Identifies the items by reference to which a company is to determine the amount of any distribution it may make. These are:

a) profits, losses, assets and liabilities;

b) provisions of any of the kinds mentioned in paragraphs 88 and 89 of Schedule 4; and

c) share capital and reserves, including undistributable reserves.

Subsection (3). Provides that the company’s accounts relevant for this purpose are (normally) the last annual accounts – ie those prepared under Part VII and laid, in compliance with section 241, in respect of the last preceding accounting reference period. This however is subject to

Subsection (4), which deals with two special cases:

a) where a distribution would contravene the relevant sections if reference were only made to the last annual accounts; and

b) where the distribution is proposed in the company’s first accounting period, or where no accounts have been laid in respect of that period.

The relevant accounts – those necessary to enable a reasonable judgement to be made of the items in subsection (2) – are in case a), “interim accounts” and in case b) “initial accounts”. These are dealt with in more detail in sections 272 and 273 – see below.
(Note that interim accounts are only needed for a dividend if the most recent annual accounts do not show sufficient profits available for distribution. A typical case would be where trading conditions are known to have improved dramatically, or where a profit has been realised on the sale of a major asset.)

**Subsection (5).** Provides that failure to comply with the requirements as to relevant accounts in this and the following sections will result in contravention of sections 263, 264 or 265.

**Section 271: Requirements for last annual accounts**

This section makes detailed provision as to the annual accounts needed to justify a distribution. Note that this section applies to all companies, whilst the two following sections apply only to public companies.

**Subsection (1).** Provides that where the company’s last annual accounts are the only ones relevant, the provisions of the following subsections apply.

**Subsection (2).** Provides that:

- the accounts must have been properly prepared in accordance with the Act, or properly prepared subject only to matters not material for determining, by reference to the items in section 270(2), whether a distribution would contravene the relevant section; and, without prejudice to this

- the balance sheet must give a true and fair view of the state of the company’s affairs as at the balance sheet date, and the profit and loss account must give a true and fair view of the profit or loss for the accounting period.

It is for consideration whether it is necessary to have belt and braces here. “Properly prepared” must surely imply “true and fair view”.

**Subsection (3).** Provides that the auditors must have reported on the accounts. If their report is qualified, the following subsection applies.
Subsection (4). Provides that if the auditors’ report is qualified, the auditors must state whether in their opinion the matter in respect of which the report is qualified is material for determining whether a distribution would contravene the relevant section. A copy of the statement must have been laid before the company in general meeting (subject to modifications in section 252 where an elective resolution is in force).

Subsection (5). Provides that the auditors’ statement under subsection (4) – that the qualification is immaterial to the distribution, may relate either to a particular distribution alone or to that and future distributions, whether or not proposed. (The qualification may relate to something unrelated to profits or assets – eg directors’ remuneration; in such a case a further distribution in the same accounting period should not need a second auditors’ statement in the same terms as the first.)

Section 272: Requirements for interim accounts

(This section applies only to public companies. Private companies must still produce interim accounts in the situation described in section 270(4)(a), but the accounts will be for the guidance of the directors only; there are no statutory requirements for them.)

Subsection (1). Is introductory – the requirements for interim accounts of a public company are as in the following subsections.

Subsection (2). Provides that the accounts must have been properly prepared in accordance with the Act, or properly prepared subject only to matters not material for determining, by reference to the items in section 270(2), whether a distribution would contravene the relevant section.

Subsection (3). Defines “properly prepared” for interim accounts. They must comply with section 226, applying that section and Schedule 4 with such modifications as are necessary because the accounts are not prepared in respect of an accounting reference period. The balance sheet must have been signed in accordance with section 233. In addition, and without prejudice to this, the balance sheet must give a true and fair view of the state of the company’s affairs as at the balance sheet date, and the profit and loss account must give a true and fair view of the profit or loss for the period to which the accounts relate. (See comment on section 271(2).)
Subsection (4). Provides that a copy of the interim accounts must have been delivered to the registrar (a standard requirement for annual accounts).

Subsection (5). Provides that if the accounts are not in English, a translation certified as correct must also have been delivered to the registrar. This does not apply where accounts are permitted to be delivered in Welsh. In that case section 710B(6) applies and the registrar of companies will have the accounts translated and bear the cost of translation.

Note that there is no requirement for interim accounts to be the subject of an auditors’ report. The auditors’ report on the preceding annual accounts was presumably thought to suffice.

Section 273: Requirements for initial accounts

Subsection (1). Is introductory – the requirements for initial accounts of a public company are as in the following subsections.

Subsection (2). Provides that the accounts must have been properly prepared in accordance with the Act, or properly prepared subject only to matters not material for determining, by reference to the items in section 270(2), whether a distribution would contravene the relevant section.

Subsection (3). Applies to initial accounts the definition of “properly prepared” included for interim accounts in section 272(3) – (see above, including comment).

Subsection (4). Provides that the auditors must have reported on whether the accounts have been properly prepared. If their report is qualified, the following subsection applies.

Subsection (5). Provides that the auditors must, if their report is qualified, state whether in their opinion the matter in respect of which the report is qualified is material for determining whether the distribution contravenes the relevant sections.

Subsection (6). Provides that a copy of the initial accounts, of the auditor’s report and of the auditors’ statement (if any) under subsection (5) must have been delivered to the registrar.
Subsection (7). Provides that if the accounts are, or the auditors’ report or statement is, not in English, a translation certified as correct must also have been delivered to the registrar. Where the accounts etc are in Welsh, section 710B(6) applies and the registrar of companies will have the accounts translated and bear the cost of translation.

Section 274: Method of applying section 270 to successive distributions

Subsection (1). Provides that where a company is determining by reference to particular accounts whether a distribution contravenes the relevant section, and other distributions have already been made by reference to those same accounts, the company must consider the cumulative total of all the distributions when determining whether the latest one may be made.

Subsection (2). Lists all the categories of payment which are to count as distributions for the purpose of this section, whether or not they count as distributions for any other purpose. They are:

a) financial assistance lawfully given by a public company under one of the exceptions to section 151;

b) financial assistance lawfully given by a private company under the “whitewash” procedure;

c) unlawful financial assistance, if it reduces net assets or increases net liabilities;

d) payments in respect of purchase of own shares, except where this is lawfully made other than out of distributable profits (ie out of the proceeds of a new issue). The wording here appears to exclude payments in redemption of redeemable shares; and

e) payment for the right to acquire the company’s shares (section 168).
Subsection (3). Contains definitions for this section. “Financial assistance” means the same as in Chapter VI of Part V (see section 152(1)(a)). “Net assets” has the same meaning as in section 154(2)(a) – the more relaxed definition, using book values. “Net liabilities” in relation to financial assistance by a company means the excess of aggregate liabilities over aggregate assets using book values for both. (This applies to a calculation for the purpose of this section the form of assets test required by the Second Directive to be imposed on public companies in the context of financial assistance – see above on section 154(2).)

Subsection (4). Extends to subsections (2) and (3) of this section the regulation making power conferred on the Secretary of State by section 179 qv.

Section 275: Treatment of assets in the relevant accounts

This section contains a number of technical provisions refining the accounting provisions in the preceding sections.

Subsection (1). Qualifies what is to count as a provision for the purposes of profits in section 263 and of net assets in section 264. The effect is that a “provision” of the kind described in paragraphs 88 and 89 of Schedule 4 is to be treated as a realised loss. There is an exception to this, namely if the provision represents the diminution in the value of a fixed asset appearing on a revaluation of all the company’s fixed assets, or of all the fixed assets other than goodwill.

Subsection (2). Concerns the case where a fixed asset is revalued upwards, resulting in an unrealised profit. If in such a case in a given period a sum is written off or retained for depreciation, then the difference between that sum, and the equivalent sum which would have been written off or retained had the asset not been revalued, is to be treated as a realised profit made over that period.

Subsection (3). Provides that where there is no record of the original cost of an asset, or none can be obtained without unreasonable cost or delay, the company may take the value of the asset in the earliest available record, made on or after its acquisition by the company, for the purpose of determining whether the company has made a profit or a loss on it.
Subsection (4). Provides that any consideration by the directors of the value at a particular time of a fixed asset is to be treated as a revaluation for the purpose of determining whether a revaluation of the company’s fixed assets as required for purposes of the exception from subsection (1) has taken place. This is subject to subsection (6) – see below.

Subsection (5). Qualifies subsection (4). Where a “deemed” revaluation has taken place under subsection (4), the exception from subsection (1) is only available if the aggregate value of the fixed assets is greater than the value appearing in the annual accounts.

Subsection (6). Provides that where there is a requirement under the preceding sections for properly prepared accounts (sections 271(2), 272(2) and 273(2)), the “deemed” revaluation facility (subsection (4) above) is only available if it is stated in a note to the accounts:

a) that the directors have considered the value at any time of any fixed assets of the company without actually revaluing those assets;

b) that they are satisfied that the aggregate value of those assets at the time was not less than the aggregate amount at which they were valued in the accounts; and

c) that the relevant items are accordingly stated in the relevant accounts on the basis that a revaluation of the company’s fixed assets, which by virtue of subsections (4) and (5) included the assets in question, took place at that time.
Section 276: Distributions in kind

This section provides that where a company makes a distribution of, or including, a non-cash asset, and part of the value of that asset in the relevant accounts represents an unrealised profit, that profit is to be treated as realised for the purpose of determining the lawfulness of the distribution in accordance with this Part and for the purpose of transfer to the profit and loss account under the accounting rules in Schedules 4 and 8 in connection with the making of the distribution. This was introduced in order to facilitate mergers involving a distribution of assets: improved tax treatment for certain such mergers was introduced about the time of the 1980 Act and without the amendment in this section the objective might have been frustrated. (Non-cash asset” is defined in section 739.)

Section 277: Consequences of unlawful distribution

Subsection (1). Provides that where a distribution is made by a company in contravention of this Part, and the member receiving the distribution knew, or had reasonable grounds for belief, that the distribution was unlawful, the member is liable to repay it. In the case of a non-cash distribution, the liability is to repay an equivalent sum.

This implements Article 16 of the Second Directive for public companies and extends it to private companies. (In fact, the sanction is unlikely to have much force for large public companies, since shareholders will not typically know whether a distribution is lawful under Part VIII; the sanction may be more relevant to private companies.)

Subsection (2). Provides that subsection (1) is without prejudice to any other obligation a member might have to repay an unlawful distribution. (Gower, 5th edition, p.259, comments that it is difficult to identify any such obligation on a member as such. Tolley [D7534] comments that there may be liability to repay as a constructive trustee.) The subsection also makes clear that subsection (1) does not cover the repayment of unlawful financial assistance, or of money received on an (unlawful) redemption or purchase of own shares.

Subsection (3). Provides that regulation making power in section 179 (qv) is extended to cover the provisions of subsection (2).
The note on the provision in the 1980 Act corresponding to this section explains that it was decided not to impose criminal sanctions on directors for the breach of Part VIII since the directors could be required to make good the loss to the company from their personal resources (under common law). There are no criminal sanctions, either, for unlawful redemption or purchase of own shares, but there are for unlawful financial assistance. It is hard to justify the discrepancy by reference to the statute alone, but the liability of directors under common law in each of these situations may also be relevant. It is proposed to examine separately the question of sanctions across the whole of the capital maintenance provisions, if not more widely.

Section 278: Saving for provisions in Articles operative before Act of 1980

This section provides that where, before 22 December 1980, a company was authorised by a provision in its Articles to apply unrealised profits in paying up in full or in part bonus shares to be issued to members, that provision should continue as authority for profits to be applied in that way afterwards.

The point of this is explained by Gower (Fifth edition, p. 260). Before the 1980 Act, both realised and unrealised profits could be distributed. It was common for Articles to define the profits which might be capitalised as the amount (inter alia) “...otherwise available for distribution” (Table A, 1948, Article 128). But the effect of section 263 (qv) is that unrealised profits are no longer “available for distribution”. So the wording of Article 128, as applied to that of section 263, would have removed the freedom of companies to apply unrealised profits to the payment up of bonus shares, notwithstanding that in section 263(2)(a) an issue of bonus shares is expressly excluded from the definition of “distribution”. This anomaly was corrected for the future by the addition of Article 128A to Table A 1948 and later by the inclusion of appropriate wording in Article 110 of Table A 1985. Section 278 was included to cover companies with only Article 128 or equivalent wording in their Articles, who might well not have realised that they had lost the ability to use unrealised profits for paying up bonus shares.

It is for consideration whether, more than 20 years later, it is necessary to retain this provision.
Section 279: Distributions by banking or insurance companies

This section introduces the technical modifications in Schedule 11 which modify “relevant accounts” for the purposes of Part VIII to take account of the specific accounting requirements on banking and insurance companies.

Section 280: Definitions for Part VIII

This section provides definitions of “capitalisation” and profits and losses for the interpretation of this Part. “Capitalisation” means either paying up unissued shares as fully or partly paid bonus shares to be allotted to members or transferring profits to capital redemption reserve. Profits and losses of any description are to include profits and losses made at any time and, except where the context otherwise requires – ie in the case of investment companies – they are to include both capital and revenue profits and losses.

Section 281: Savings for other restraints on distribution

This section makes clear that Part VIII is without prejudice to tighter restrictions on distribution in any other enactment or rule of law, or in the company’s Memorandum or Articles. It is proposed to reverse the position as regards any rule of law (see above under section 263). Tighter restrictions in an enactment or in the company’s constitution will continue to prevail. The reference to the Memorandum or Articles will be replaced by a reference to the company’s constitution as a consequence of the proposals on company formation.