THE CAPITAL MAINTENANCE DOCTRINE PROVIDES ESSENTIAL PROTECTION TO CORPORATE CREDITORS: MYTH OR REALITY?

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ABSTRACT

The capital maintenance doctrine is concerned with the rules restricting the freedom of companies to return to their shareholders funds which were originally subscribed for shares. The doctrine, which was initially developed by the courts in the 19th century, and later structured by statutes found its roots in the House of Lords decision in Trevor v Whitworth. There, the courts absolutely prohibited a company from reducing its capital through the repurchase of its own shares. The prohibition was thought to be necessary to protect creditors against losses that could result from the diminution of the company’s share capital on which creditors rely for their protection. The doctrine, while restricting share buy-backs and reduction of capital provided the basis of a number of subsidiary rules regulating corporate activities that indirectly reduce the company's capital such as, a company financing the purchase of its own shares, and the prohibition on a company paying dividends otherwise than out of profit. The central argument of the thesis is that the protection afforded creditors under the traditional maintenance of capital doctrine is a 'mirage-like' abstraction, because share capital provides an illusory protection against corporate failure and creditors do not rely on it either for protection or to secure their debts.

Through case and statutory law, this study provides a comprehensive analysis of the doctrine in its different aspects as applied in Australia and the United Kingdom. The study compiles, re-examines, reviews and analyses existing and proposed legislation for the protection of corporate stakeholders. It puts forward a set of specific and general proposals which recommend a shift from the maintenance of share capital to the maintenance of the assets of a limited company. Through this approach, the study suggests that future regulation of the capital maintenance doctrine can best be achieved through a dual solvency requirement, supplemented by a debt-to-equity ratio test. This model would be reinforced by other mechanisms such as the insolvent trading provisions, loan and contractual agreements and the oppression remedy provisions. This model provides a coherent and comprehensive strategy of effectively protecting creditors and shareholders in Australia and other common law jurisdictions for the 21st century.
TABLE OF CONTENTS

Acknowledgement......................................................................................... I
Abstract........................................................................................................ II

INTRODUCTION.......................................................................................... I

CHAPTER ONE: DEFINITIONS AND NATURE OF THIS STUDY..................10
1.1 Introduction............................................................................................10
1.2 The Concept of Capital..........................................................................11
  1.2.1 Capital as a Trust Fund.................................................................12
  1.2.2 Fixed and Circulating Capital......................................................14
  1.2.3 Capital as a Res or Quantum......................................................16
  1.2.4 Share Capital..................................................................................17
1.3 The Meaning, Justification and Weakness of Maintenance of Capital.....20
  1.3.1 Defining ‘Maintenance of Capital’................................................20
  1.3.2 Justification for the Traditional Maintenance of Capital Doctrine...23
    1.3.2.1 Protection from Liability......................................................23
    1.3.2.2 Preservation of a Minimum of Assets.................................24
    1.3.2.3 Restricting Dividend Distribution to Profits..........................25
    1.3.2.4 Protection from Inadequate Consideration for Issue of Shares...25
    1.3.2.5 Protection from Undercapitalisation....................................26
    1.3.2.6 Prohibition from Share Buy-back and Reduction of Capital......27
    1.3.2.7 Prevention of Asset-stripping Take-over...............................28
    1.3.2.8 Preservation of the Ranking and Risk Position.......................29
    1.3.3 General Criticisms of the Common Law Share Capital Maintenance Doctrine...29
      1.3.3.1 An Excessive Response to Priority Position of Creditors.........29
      1.3.3.2 Share Capital Provides Inadequate Protection....................30
    1.3.3.3 Capital Maintenance Doctrine is not a Capital Adequacy Requirement...33
    1.3.3.4 The Doctrine Imposes Substantial Costs on Companies...........34
    1.3.3.5 The Broad Prohibitions on Share Capital Transactions are Irrelevant...35
    1.3.3.6 Minimum Paid-in Capital Requirement Provides an Illusory Protection...36
    1.3.3.7 The ‘No Discount Rule’ may be Misleading...........................37
    1.3.3.8 The Dividend Restriction Inhibits Signaling Function of Dividend Policy..37
    1.3.3.9 Capital Maintenance Rules are Inadequate on Efficiency Grounds.....38
1.4 Conclusion.............................................................................................39
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>CHAPTER TWO: SHARE BUY-BACKS</td>
<td>41</td>
</tr>
<tr>
<td>2.1 Introduction</td>
<td>41</td>
</tr>
<tr>
<td>2.2 History of the Legislation</td>
<td>42</td>
</tr>
<tr>
<td>2.2.1 English History</td>
<td>43</td>
</tr>
<tr>
<td>2.2.1.1 An Overview of the Present Legislation</td>
<td>53</td>
</tr>
<tr>
<td>2.2.2 Australian History</td>
<td>57</td>
</tr>
<tr>
<td>2.3 The Mechanisms of the Current Statutory Buy-Back Regime</td>
<td>67</td>
</tr>
<tr>
<td>2.3.1 Relationship between Reductions of Capital and Buy-Back</td>
<td>67</td>
</tr>
<tr>
<td>2.3.2 Methods and Procedures of Share Buy-Back</td>
<td>68</td>
</tr>
<tr>
<td>2.3.2.1 Minimum Holding Buy-Back</td>
<td>68</td>
</tr>
<tr>
<td>2.3.2.2 On Market Buy-Back</td>
<td>69</td>
</tr>
<tr>
<td>2.3.2.3 Equal Access Scheme</td>
<td>71</td>
</tr>
<tr>
<td>2.3.2.4 Employee Share Scheme</td>
<td>75</td>
</tr>
<tr>
<td>2.3.2.5 Selective Buy-Back</td>
<td>77</td>
</tr>
<tr>
<td>2.3.2.6 The ‘10/12’ Limitation</td>
<td>80</td>
</tr>
<tr>
<td>2.4 Some Policy Issues</td>
<td>83</td>
</tr>
<tr>
<td>2.4.1 Status and Validity of Shares Bought-Back</td>
<td>83</td>
</tr>
<tr>
<td>2.5 Creditors and Shareholders Protection</td>
<td>86</td>
</tr>
<tr>
<td>2.5.1 Creditor Perspective</td>
<td>86</td>
</tr>
<tr>
<td>2.5.1.1 Protection from Director’s and Shareholder Liability</td>
<td>86</td>
</tr>
<tr>
<td>2.5.1.2 Protection from Solvency Test</td>
<td>89</td>
</tr>
<tr>
<td>2.5.2 Shareholder Perspective</td>
<td>92</td>
</tr>
<tr>
<td>2.5.2.1 Protection under the Shareholder Approval Provision</td>
<td>92</td>
</tr>
<tr>
<td>2.5.2.2 Protection under the Disclosure and Insider Trading Provision</td>
<td>96</td>
</tr>
<tr>
<td>2.6 Conclusion</td>
<td>99</td>
</tr>
</tbody>
</table>

| CHAPTER THREE: SHARE CAPITAL REDUCTION                                 | 100  |
| 3.1 Introduction                                                       | 100  |
| 3.2 History of the Legislation                                         | 102  |
| 3.2.1 English History                                                  | 103  |
| 3.2.2 Australian History                                               | 108  |
| 3.3 The Mechanics of the Current Reduction of Capital Regime           | 115  |
| 3.3.1 General Procedures                                               | 115  |
| 3.3.2 Equal and Selective Reduction of Capital                         | 118  |
| 3.3.2.1 Equal Reduction of Capital                                     | 118  |
| 3.3.2.2 Selective Share Capital Reduction                              | 120  |
| 3.3.3 Loss Reduction of Capital (s. 258F)                               | 122  |
| 3.3.4 Relationship between a Reduction of Capital and Variation of Rights | 126  |
| 3.3.4.1 Does a Reduction of Share Capital vary (abrogate) Class Rights? | 127  |
| 3.3.4.1.1 The Popular Approach                                         | 128  |
| 3.3.4.1.2 The Moderate Approach                                        | 136  |
| 3.4 Protection of Creditors and Shareholders under a Reduction of Capital | 140  |
| 3.4.1 Creditor Protection                                              | 141  |
| 3.4.2 Shareholder Protection                                           | 144  |
| 3.4.2.1 Protection from the Special Resolutions and Disclosure Procedures | 144  |
| 3.4.2.1.1 Application of s 256(2) (a)                                   | 145  |
3.4.2.1.2 The Procedure under s 256C (2) (b).................................149
3.4.2.1.3 Enhanced Disclosure Procedure................................151
3.4.2.2 Protection from the ‘Fairness’ Procedure.........................154
3.4.2.2.1 Common Law Approach........................................155
3.4.2.2.2 The Current Approach............................................157
3.4.2.2.2.1 Difficulties in the Adequacy of Consideration Criterion.....160
3.4.2.2.2.2 Relevancy or Irrelevancy of Schemes of Arrangements &Takeovers..162

CHAPTER FOUR: FINANCIAL ASSISTANCE FOR THE PURCHASE OF
COMPANY SHARES.................................................................165
4.1 Introduction........................................................................165
4.2 Legislation Framework and History of the Provisions...............167
4.2.1 The English History.......................................................168
4.2.2 Australia’s Legislative History........................................179
4.3. A Comparative Amelioration – The Current Australian Law......187
4.3.1 The Section 260A (1) and the Materially Prejudice Provision....187
4.3.2 Section 260C, Exemptions and the Question of Dividend Distribution....191
4.3.3 Consequences for Breach of s 260A..................................194
4.3.4 Some Definitional and Policy Issues................................196
4.3.4.1 Problems of Defining and Determining Financial Assistance.....196
4.3.4.1.1 The Narrower View (“The Impoverishment” Theory)........197
4.3.4.1.2 The Broader View (“The Purpose” Theory).......................201
4.3.4.2 Financial Assistance and Take-over Financing....................205
4.3.4.3 Regulation of Financial Assistance and Conflicts of Interests........213
4.3.4.3.1 Director’s Duties and the s 588G Duty Provisions............214
4.3.4.3.2 Related Party Provisions.............................................216
4.4 Conclusion........................................................................219

CHAPTER FIVE: DIVIDEND DISTRIBUTION............................221
5.1 Introduction........................................................................221
5.2 Legislation Development....................................................222
5.2.1 English History.............................................................223
5.2.2 Australian History........................................................233
5.3 Some Common Law and Statutory Principles for the Determination and
Ascertainment of Dividend and Profits......................................239
5.3.1 Lost of fixed Assets need not be made Good before Paying a Dividend....239
5.3.2 Should Provision be made for Depreciation?.........................243
5.3.3 Realised and Unrealised Profits and Losses........................248
5.3.4 Payment of Dividends from Current Years Trading Profit despite Past Losses....251
5.4 Some Policy Problems on Distribution of Dividends out of Profits.....257
5.4.1 Problem of Defining Profits.............................................257
5.4.1.1 Judicial Explanations......................................................257
5.4.1.2 Accounting and other Explanations................................261
5.4.2 When Must Profits to fund a Dividend Exists?.......................263
5.5 Consequences and Remedies for Unlawful Dividend Payment......265
5.5.1 Remedy for Unlawful Dividend Payments (Unauthorised Distribution) .................. 265
5.5.2 Liability on Members and Directors with Constructive Knowledge ............... 267
5.5.3 Recovery from Innocent (Non Knowledgeable) Recipients ......................... 271
5.5.3.1 Recovery of Improper Dividends from Innocent Directors .................... 271
5.5.3.2 Tracing Unlawful Dividends from Innocent Shareholders ..................... 275
5.6 An Optimum Approach to Regulating Dividend Distributions .......................... 278
5.6.1 Solvency Requirement: A New Test for the Legality of a dividend distribution .. 278
5.7 Conclusion ....................................................................................... 284

CHAPTER SIX: A MINIMUM CAPITALISATION REQUIREMENT ....................... 286
6.1 Introduction ..................................................................................... 286
6.2 Legislation History (United Kingdom) ............................................... 288
6.3 Arguments for a Minimum Capital Requirement ...................................... 297
6.3.1 Protect Creditors and Prevents Frivolous Incorporation ......................... 297
6.3.2 Serves as a Signaling Device ......................................................... 298
6.3.3 Facilitates Borrowing ...................................................................... 299
6.3.4 Act as a Capital Adequacy and Asset Backing Requirement ................... 300
6.3.5 Can be used to Pierce the Corporate Veil .......................................... 302
6.3.6 A Risk Allocation Device .................................................................. 303
6.4 Argument against a Minimum Paid-up Capital ......................................... 304
6.4.1 Illusory Protection to Shareholders and Creditors .................................. 304
6.4.2 Capital Maintenance Doctrine is not a Capital Adequacy Requirement ....... 306
6.4.3 The Minimum Paid-in-Capital is Insignificant and Misleading ............... 311
6.4.4 Complications in Type of Asset-Payment and the Valuation of Non-cash Shares 313
6.4.5 Unnecessary Barrier to Incorporation .............................................. 314
6.4.6 Difficulties of Setting an Appropriate Level (Ceiling) ........................... 315
6.4.7 Conflicts of Laws ............................................................................ 316
6.5 An Alternative Regime: A Statutory Guarantee Fund ................................. 318
6.6 Conclusion ....................................................................................... 328

CHAPTER SEVEN: ADEQUACY OF CONSIDERATION FOR THE ISSUE OF SHARES .................................................. 329
7.1 Introduction ..................................................................................... 329
7.2 Legislative History ............................................................................ 331
7.2.1. English History ............................................................................ 331
7.2.1.1. Share Premium ........................................................................ 331
7.2.1.2. Discount Share Issues .............................................................. 333
7.2.1.3. Non-Cash Consideration ......................................................... 338
7.2.2. Australian History ........................................................................ 341
7.2.2.1. Share Premium ........................................................................ 341
7.2.2.2. Discount Share Issue .............................................................. 346
7.2.2.3. Non-Cash Consideration ......................................................... 349
7.3. Some Policy Problems Relating to the Consideration for the Issue of Shares... 352
7.3.1. Payments for Non-Cash Consideration and the Principle of Circuity ....... 352
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.3.1.1. Discharging a Specialty Debt</td>
<td>352</td>
</tr>
<tr>
<td>7.3.1.1.1. Specialty Debt and Share Premium</td>
<td>353</td>
</tr>
<tr>
<td>7.3.1.2.2. Extinguishment of a Specialty Debt by Future Supply of Goods and Services</td>
<td>354</td>
</tr>
<tr>
<td>7.3.1.2.3. Adequacy of Past or Future Consideration for Shares</td>
<td>365</td>
</tr>
<tr>
<td>7.3.1.2.4 Extinguishment of Liability by Cross-payments and Set-Off</td>
<td>372</td>
</tr>
<tr>
<td>7.3.1.2.3.1. Cash Off-Setting and the Capital Maintenance Doctrine</td>
<td>381</td>
</tr>
<tr>
<td>7.4. Regulation and Valuation of Non-Cash Consideration for Shares</td>
<td>383</td>
</tr>
<tr>
<td>7.4.1. The Director’s Honest Estimate Test</td>
<td>384</td>
</tr>
<tr>
<td>7.4.2. Independent Expert Valuation</td>
<td>389</td>
</tr>
<tr>
<td>7.5. Conclusion</td>
<td>394</td>
</tr>
</tbody>
</table>

### CHAPTER EIGHT: THE WAY FORWARD: RECOMMENDATIONS FOR OPTIMUM REGULATION AND CREDITOR ROTATION

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.1 Introduction</td>
<td>395</td>
</tr>
<tr>
<td>8.2 Optimum Regulation: Solvency Requirement and Debt-to-Equity Ratio</td>
<td>396</td>
</tr>
<tr>
<td>8.2.1 The Solvency Requirements</td>
<td>397</td>
</tr>
<tr>
<td>8.2.1.1 Cash Flow Solvency</td>
<td>398</td>
</tr>
<tr>
<td>8.2.1.1.1 Judicial Explanation</td>
<td>399</td>
</tr>
<tr>
<td>8.2.1.1.2 Difficulties with the Cash Flow Test</td>
<td>400</td>
</tr>
<tr>
<td>8.2.1.2 Balance Sheet Solvency</td>
<td>401</td>
</tr>
<tr>
<td>8.2.1.2.1 Some Problems with the Balance Sheet Test</td>
<td>403</td>
</tr>
<tr>
<td>8.2.1.2.2 Some General Problems with a Solvency Approach</td>
<td>404</td>
</tr>
<tr>
<td>8.2.1.3 Cumulative Dual Solvency Approach</td>
<td>405</td>
</tr>
<tr>
<td>8.2.2 The Debt-Equity-Ratio</td>
<td>408</td>
</tr>
<tr>
<td>8.2.2.1 Total Ratio Test</td>
<td>409</td>
</tr>
<tr>
<td>8.2.2.2 Current Ratio Test</td>
<td>410</td>
</tr>
<tr>
<td>8.2.2.3 The Importance of the Financial Ratio Test</td>
<td>410</td>
</tr>
<tr>
<td>8.3. Essential Protection of Creditors and Shareholders</td>
<td>412</td>
</tr>
<tr>
<td>8.3.1 Insolvent Trading Provisions</td>
<td>412</td>
</tr>
<tr>
<td>8.3.1.1 An Overview</td>
<td>412</td>
</tr>
<tr>
<td>8.3.1.2 Insolvent Trading Provisions, Maintenance of Capital &amp; Creditor Protection</td>
<td>414</td>
</tr>
<tr>
<td>8.3.1.3 The Beauty of the Insolvent Trading Provisions in Protecting Creditors</td>
<td>416</td>
</tr>
<tr>
<td>8.3.1.3.1 Swelling of Corporate Resources</td>
<td>416</td>
</tr>
<tr>
<td>8.3.1.3.2 Protection of Creditors</td>
<td>417</td>
</tr>
<tr>
<td>8.3.1.3.3 Deterrent Effect</td>
<td>419</td>
</tr>
<tr>
<td>8.3.1.4 Some Difficulties in the Implementation of the Insolvent Trading Law</td>
<td>419</td>
</tr>
<tr>
<td>8.3.1.4.1 Terminological Difficulties</td>
<td>419</td>
</tr>
<tr>
<td>8.3.1.4.2 Insolvent Trading Provisions do not Provide Unqualified Protection</td>
<td>422</td>
</tr>
<tr>
<td>8.3.2 Contractual Covenants (Loan and Debt Covenants)</td>
<td>423</td>
</tr>
<tr>
<td>8.3.2.1 Advantages and Role of Bond Covenants</td>
<td>426</td>
</tr>
<tr>
<td>8.3.2.1.1 Protects Secure and Unsecured creditors</td>
<td>426</td>
</tr>
<tr>
<td>8.3.2.1.2 Reduced Bonding Costs</td>
<td>427</td>
</tr>
<tr>
<td>8.3.2.1.3 Reduces Conflicts of Interest</td>
<td>427</td>
</tr>
<tr>
<td>8.3.2.1.4 Control Managerial Conduct</td>
<td>429</td>
</tr>
<tr>
<td>8.3.3 Oppression Remedy Provisions</td>
<td>430</td>
</tr>
<tr>
<td>8.3.3.1 Statutory Application</td>
<td>430</td>
</tr>
</tbody>
</table>
8.3.3.2 Share Capital Transactions and Conduct which may trigger Oppression...435
8.3.3.3 Some Advantages of the Oppression Remedy Provision......................437
8.3.3.3.1 Protects Existing and Former Shareholders.................................437
8.3.3.3.2 Equality in Treatment..............................................................437
8.3.3.3.3 Winding-up Remedy......................................................................439
8.4. Conclusion: Whither the Maintenance of Capital Doctrine?..................441
Bibliography..........................................................................................446
INTRODUCTION

This thesis focuses on a key aspect of Corporate and Finance Law, namely the capital maintenance doctrine as applied to closely-held and publicly-held corporations limited by shares. The topic is concerned with the rules which restrict the freedom of companies to return to shareholders funds which were originally subscribed for shares. The study comprehensively re-examines maintenance of capital and the legislation that deals with it in an Anglo-Australian context. The research is undertaken in order to provide an analytical review of the doctrine in the light of recent developments in statutory and case law in Australia and internationally. Finally, the thesis elaborates general recommendations for future regulation of the doctrine and optimum ways to protect corporate stakeholders.

Background

Central to the regulations of companies having a share capital in the 19th century, was the importance of a company maintaining its capital. This was seen as of particular importance for the creditors of the company. In Re Banking Exchange Co, (Flitcroft's Case) Jessel MR explained why that is so:

A limited company by its memorandum of association declares that its capital is to be applied for the purposes of the business. It cannot reduce its capital except in the manner and with the safe guards provided by statute...[T]here is a statement that the capital shall be applied for the purposes of the business and on the faith of that statement which is sometimes said to be an implied contract with creditors, people dealing with the company give it credit. The creditor has no debtor but that impalpable thing the corporation which has no property except the assets of the business. The creditors, therefore, I may say gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business and he has therefore a right to say that the corporation shall keep its capital and not return to its shareholders though it may be a right which he cannot enforce otherwise than by a winding-up order.

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1 Other International jurisdictions considered include, United Kingdom, New Zealand, Canada, Delaware and California.
2 (1882) 21 Ch D 519.
3 Ibid 533-534.
The need to maintain capital, led to the development and formulation of what become universally known as the ‘Capital Maintenance Doctrine’. This doctrine was initially developed by the courts and in subsequent years was structured by statute to off-set some of the risks stemming from limited liability. The foundation stone was the House of Lord’s decision in *Trevor v Whitworth*.\(^4\) There, the courts held on grounds of policy that it was unlawful for a company to repurchase its own shares even if it was expressly authorized by its constitution to do so. This was thought to be necessary to protect creditors of the company against losses that could result from the diminution of the company’s capital. Lord Watson explained the rationale of creditor protection thus:

Paid-up capital may be diminished or lost in the company’s trading; that’s a result which no legislation can prevent; but persons who deal with and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out except in the legitimate course of its business.\(^5\)

The doctrine, apart from prohibiting a company from buying-back (repurchasing) its own shares or reducing its capital, provided the basis of a number of subsidiary rules, regulating corporate activities that indirectly reduce the company’s capital such as:

- The prohibition against a company financing the purchase of its own shares, and
- The prohibition against a company paying dividends otherwise than out of profits.

The doctrine also covers the rules that ensure full value is received for shares and the requirement that a minimum amount of share capital be subscribed before a company commences business.\(^6\) However, it has become apparent that share capital plays only a small role in lending decisions. Creditors and shareholders have much more sophisticated means to protect themselves and secure repayments of their debts. In modern corporate

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\(^4\) (1887) 12 App Cas. 409. The universal doctrine became deeply rooted in the common law and many corporate statutes in jurisdictions modeled from the English. It found expression in the then Companies Acts of Australia. In the U.S where the capital maintenance is not deeply rooted the trust fund doctrine, analogous to the capital maintenance doctrine was developed by Justice Story in *Wood v Dammer*, 30 F Cas 435 (1824).

\(^5\) Ibid 423-424.

\(^6\) The purpose of the minimum paid-in capital as understood by European Member States where this requirement is deeply entrenched was to reinforce the capital maintenance doctrine, by preventing the abuses stemming from limited liability. See, Great Britain, Company Review Steering Group, Modern Company Law for a Competitive Economy, “Company Formation and Capital Maintenance” (A consultation Document) (1999) vi-vii.
law, most of the weaknesses of the common law doctrine have been exposed causing the courts and legislatives to modify the doctrine in diverse ways, placing the capital maintenance doctrine in its cross-roads.

The Role of this Study
Despite the long history of the capital maintenance doctrine in common law jurisdictions and much academic literature, relatively little attention has been given to the suitability of the traditional capital maintenance rules for contemporary commercial conditions. Most academic literature tends to uncritically assume the doctrine without adequate evaluation on how it might be fine-tuned to protect corporate stakeholders. Others, arguing from an economic perspective, ignore the importance of legal rules (regulations) in shaping the doctrine. Others focus only on one aspect of the doctrine either theoretically and empirically (especially on share buy-backs). There is no study which has comprehensively developed the history of the various limbs of the doctrine nor, comprehensively reviewed the adequacy of the current Australian share capital maintenance provisions in terms of the protection they afford creditors and shareholders.

The doctrine of maintenance of capital is an issue of importance to the judiciary and lawyers but is also important to accountants, economists, the securities market, investors (creditors and shareholders) and the government. Given the importance of equity and debt securities in corporate finance, creditors would quite often want assurance that their debts are paid or their security guaranteed. Shareholders on their part will wish that the corporation’s business will generate enough profits to pay high dividends. Management and directors will want to secure their position in control. The interests of the various

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7 For example, the ‘Trust Fund’ doctrine has been completely eroded in the American jurisdictions.
8 Cf Australian Corporations Law Simplification Committee, Share Capital Rules, Proposals for Simplification (November, 1994).
stakeholders are bound to clash, whenever, distributions and other payments are made to shareholders out of corporate resources without adequate safeguards regulating distribution and payments.

It is in light of the growing concern from corporate creditors and minority shareholders, and from the areas of corporate finance law, insolvency law, business and securities laws and concerns from international dimension, that this study seeks to bring together and examine what may be loopholes and deficiencies in the current capital maintenance rules in Australia and provide recommendations for optimum implementation of the doctrine in the future.

The essential questions of the study are:

- What is ‘capital’ and the ‘maintenance of capital’?
- Is the common law maintenance of capital doctrine an adequate mechanism for protecting creditors or even shareholders? What are its strengths and weaknesses?
- How has the maintenance of capital doctrine developed in the United Kingdom and Australia?
- From a comparative perspective, are the current Australian share capital maintenance provisions an ‘ideal model’?
- Which instruments, legislative and institutional measures exist which can be recommended to generally provide an optimum regulation of the doctrine and to effectively protect corporate stakeholders for the future?

To answer the above questions this thesis seeks to:

a) Establish an acceptable and unequivocal modern interpretation to the meaning of ‘capital’ and ‘maintenance of capital’, and other technical nuances that make up the doctrine.\(^{12}\)

b) Develop a comprehensive legislative framework of the various limbs of the doctrine in Anglo-Australian law.\(^{13}\)

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\(^{12}\) See chapter 1 of this study. See also, chapter 4, (defining financial assistance), chapter 5, (defining 'profits').

\(^{13}\) See, first part of chapter 2 through to chapter 7, where a legislative history is discussed in each chapter.
c) Situate the history of the legislation and a comparative implementation of the current law in Australia in the context of a policy debate.

d) Develop recommendations for future regulation of the doctrine.\textsuperscript{14}

\textbf{Specific Objective and Structure of this Thesis}

In order to re-examine, review and analyse the capital maintenance doctrine for its future development, it is important to recognize not only legal rules but also, developments in accounting, economics and financial research. The study aims initially at developing a model that situates and explains the existence, structure and operation of the doctrine, and develops other strategies and models which will provide useful insights for the future position of the doctrine in Australia and internationally.

\textbf{Structure of the study}

The study is structured into eight chapters. For the purpose of this study the capital maintenance doctrine will be subsumed into six limbs, some of which mirror the other. These include; Chapter 1, “Nature and scope of the Study”, Chapter 2, “Share Buy-Backs”. Chapter 3 “Reduction of Capital”, Chapter 4 “Financial assistance”, Chapter 5 “Dividend Distribution”, Chapter 6 “Minimum Capitalisation Requirement”, Chapter 7 “Consideration for the issue of shares” and Chapter 8, “Recommendation and Conclusion”.

Chapter 2 through to Chapter 7 examine the legislative history of each sub-limb of the doctrine in the United Kingdom and Australia.\textsuperscript{15} The aim is to situate the development of the relevant sub-lims from a historical time-frame, and to demonstrate how case, statutory law, and law reform reports led to their development.\textsuperscript{16} The history is important to the theme of the study because it provides the basis for the results of the thesis found in

\textsuperscript{14} See, chapter 8 of this study.

\textsuperscript{15} It is axiomatic that you cannot purport to understand the present without knowing and understanding the past. The history of the law is crucial to its contemporary manifestation.

\textsuperscript{16} It is also importantly noteworthy that while the study provides a comprehensive historical development of each of the relevant provisions of the capital maintenance doctrine, the aim is not to critically analyse or to provide any detailed comparative analyses of each of these various sections (provisions) of the doctrine. However, while the legislative framework is simply for historical purposes, the current and relevant provisions in Australia are subject to critical assessment.
Chapter 8. This is illustrated by a shift in emphasis in contemporary jurisdictions from the maintenance of capital to the maintenance of the company’s assets through a solvency requirement.17

Chapter One, examines and clarifies the terminology, ‘capital’ and ‘maintenance of capital’ as variously used in law. It also advances and critiques the traditional rationale of the share capital doctrine. The chapter provides the basis for the results of the study which are found in chapter 8. Since the term, ‘capital’ and ‘maintenance of capital’ are given different interpretations in law and economics, it is important that an unequivocal, common meaning of the terms is applied to ensure ease of comparison amongst different jurisdictions. It will also afford better understanding of the meaning of each sub-limb of the doctrine.

Previous work that provides arguments for and against the doctrine or suggests suitable meanings for the above terms are sparse and limited in scope. In this chapter, it is argued that the various names provided by the courts, legislature and commentators as to what is capital remain historical but, that a closer and more suitable meaning of the term’ capital’ would be what is subscribed by shareholders in the business. Thus, share capital, would be the more preferable term to use for capital. It is also argued that common law rules prohibiting companies from pursuing desirable commercial ventures were unnecessarily restrictive and in most cases, prevented companies from using the full range of financing techniques available, and did not always protect creditors as was intended.

Chapter Two, explores and analyses the rules on share buy-backs. After a history of the legislation in the United Kingdom and Australia, the remaining part of the chapter provides an examination of the current buy-back regime in Australia. It seeks to evaluate the strength of the current section 257 of the Corporations Act 2001 (Cth), to ascertain, if it compares favourably with buy-back provisions in other jurisdictions.

17 For example, see, Australia’s Corporations Act 2001 (Cth), ss 256, 257 and 260; New Zealand’s Company’s Act 1993, s 4.1; Revised Model Business Corporations Act 1990, s 6.4; Canadian Business Corporations Act 1990, s 42; California Corporations Code, s 500.
In Chapter Three, the rule of share capital reduction is reviewed. This chapter which mirrors Chapter Two on buy-backs in many material respects discusses policy issues underpinning the two regimes under the current Australian law. In both chapters, drafting defects in the shareholder approval provisions are exposed and suggested regulation advanced. Other policy issues relating to creditors and shareholders are discussed.

Chapter Four, re-examines the rule which prohibits a company from financially assisting others to purchase their own shares. Section 4.2 provides a history of the legislation in both the U.K and Australia. Section 4.3ff ascertains and evaluates the rules regulating financial assistance in Australia and discusses any defects in the legislation from a comparative perspective. It provides an acceptable meaning to the term ‘financial assistance,’ raises questions and policy debate, such as whether the ‘financial improvement’ test relates to (and or) breaches the financial assistance prohibition and, questions policy problems arising in take-over financing. The mechanisms for protection of creditors and shareholders are also canvassed.

In Chapter Five, the study analytically evaluates the rule that dividends can only be paid to shareholders otherwise than out of distributable profits. The legislative history in Anglo-Australian law is first traced. The current law on dividends in Australia is then placed in a comparative perspective and some difficult questions are asked. For example, why does Australian law allow companies to pay dividends without making good past losses which contradict legislation in other comparable jurisdictions? The study also questions why the rule on dividend distribution in Australia is still deeply attached to vestiges of the traditional capital maintenance doctrine when the law, especially as concerns buy-back and reduction of capital no longer adheres to the capital maintenance doctrine. It is also argued that the current law is most obscure on the question of who is liable to restore an improperly paid dividend and who can restrain it. It is further questioned whether section 254T regulating dividends to the requirement of distributable profits rather than the solvency test impliedly required by Section 256 (reduction of
capital), s.257 (buy-back) and s.260 (financial assistance) provides a model for creditors protection.\(^{18}\)

Chapter Six, which discusses the minimum capitalisation requirement, is a subsidiary of the capital maintenance doctrine. The chapter is concerned only with the English legislation and the second European Union Company Law Directive which harmonises company law in the European Union. Australia is left out of this chapter because it does not legislate on a minimum paid-in-capital requirement. However, in assessing the strengths and weaknesses of the European ‘capital adequacy’ requirement, views from the Australian Companies and Securities Law Review Committee are advanced. The chapter traces its historical developments from an English perspective, critiques the minimum capital requirement and suggests a statutory ‘Guarantee Fund’ as a suitable alternative.

Chapter Seven, deals with the regulation of the adequacy of the consideration for shares. The history is examined from both the English and Australian perspective. The current Australian position of the regulation of both ‘cash and non-cash’ consideration are placed in a comparative debate. It is suggested that the ‘independent expert valuation’ approach is a better method of regulating and valuing non-cash consideration.

Chapter Eight, concludes the findings of the research by elaborating general recommendations for optimum regulation of the capital maintenance doctrine for Australia and other common law jurisdictions. The chapter also suggests optimum approaches on how creditors and shareholders can be adequately protected under the capital maintenance doctrine. The study recommends a shift from maintaining share capital to a ‘universally’ dual solvency requirement, reinforced by debt-to-equity ratio, insolvent trading provision, loan and debt covenants and the oppressions remedy provision. The aim of this chapter is to show the way ahead not by suggesting abolition

of the doctrine but by providing realistic avenues for the regulation of the doctrine and its likely future.

**Research Method and Sources**

This study, adopts a theoretical historical model based on case and statutory law, and a comparative analysis using legal, financial and economic literature. The principal sources on which the thesis builds are theoretical in scope. The concepts of the theoretical approach are two-fold. The first part relates to primary sources in the form of case law, legislation, Parliamentary debates, Law review Reports and government gazettes. The second relates to secondary sources mostly, academic texts, journal articles, electronic data resources and newspapers. The study uses these sources because of the conspicuous absence of a comprehensive theoretical literature of the doctrine in Anglo-Australian laws.
CHAPTER ONE
DEFINITIONS AND NATURE OF THIS STUDY

1.1. Introduction

The subject of this chapter is to provide a comprehensive and workable definition of the concepts ‘capital’ and ‘maintenance of capital’ for the purpose of the capital maintenance doctrine and also, to review some of the judicial and institutional arguments for and against the traditional maintenance of capital doctrine. The terms ‘capital’ and ‘maintenance of capital’ are frequently heard in legal, economic and financial literature, yet, there exists much confusion and uncertainty, about their meaning and function.\(^1\) Although the different approaches to the concepts have some common elements, there is still no clear or universally acceptable definition for them.\(^2\) An unequivocal, modern interpretation would allow the meaning of the individual rules that make up the doctrine to be better understood. To arrive at that definition, some thoughts and possibilities are proposed.

The chapter is structured into three main sections. Section 1.2 develops a general understanding of the concept of capital. The aim is to discuss the various meanings given to capital, but also to demonstrate that while share capital is the preferred option, the others are historical. Section 1.3 situates that concept by considering the various ways in which the rules of maintenance of capital are used by the judiciary and legislature to protect creditors. A general review of the strength and weaknesses of the doctrine will be advanced. Section 1.4 concludes, by considering whether the doctrine is likely to be a model of creditor protection or a myth. The writer argues that the traditional rationale of the capital maintenance doctrine may be an unnecessary abstraction and suggests that solvency requirements and civil or criminal liabilities on directors provide a better basis for creditor protection.

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\(^1\) At one extreme, the terms can be seen from an economic or financial point of view. The concepts can also be considered from a legal and accounting viewpoints. (Only the legal explanation is considered).

1.2. The Concept of “Capital.”

The term ‘capital’ is a marvel of inconsistencies and cannot be said to accord appropriately to a single technical meaning. 3 Although ‘capital’ may have a broad meaning, it seems shrouded in mystery, and is a perception, which is enhanced by difficulty in definition. 4 Generally, when used by economists and accountants the term refers to income, 5 while in law, it is variously referred to as a ‘trust fund’, ‘fixed and circulating capital’, capital as a ‘res or quantum’ or, ‘share (legal) capital’. Even the classic dictionary definition, is less than helpful. 6 With the development of corporations, the word ‘capital’ was taken over by the courts and, while retaining its economic meaning, acquired gradually distinct and technical meanings. 7 This section is sufficiently general to encompass all the various meanings of the term ‘capital’. However, for purposes of this study, having argued that other meanings are historical and insufficiently related to the current understanding of the maintenance of capital doctrine the writer adopts ‘share capital’ as the preferable terminology. ‘Share capital’ relates to shareholders’ contributions and is associated with equity share financing. 8

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3 See for example, Incorporated Interests Pty Ltd v Federal Commissioner of Taxation (FCT) (1943) 67 CLR 508 at 515, 520 per Latham CJ; Archibald Howie Pty Ltd v Commissioner of Stamp Duties (NSW) (1948) 17 CLR 143 at 159 (The capital of a company sometimes means the net value of a company’s assets). In a general business or mercantile sense, it may mean the assets with which a business is carried on: Jenkins v Harbour View Courts Ltd [1965] NZLR 1 at 22 per Turner J.

4 For example, in the U.S. case of Wood v Dunne, 30 F Cas 435 (1824), Justice Story, in a dividend case, referred to ‘corporate capital’ as a ‘trust fund’. Under Anglo-Australian Law, it has been variously referred to either as share or legal capital. (See, Corporations Act 2001 (Cth) s 254C; s 1426-1427 & s 1444 (referring to some key provisions making reference to share capital). Some available literature on capital include: E. Hunt, “The Trust Fund Theory and Some Substitute for it” (1903) 12 YJ 63, 63; F. Dwight, Manning and Hanke Jr, Legal Capital (New York: Foundation Press, 1990); K. K. Muenda, Legal Aspects of Corporate Capital and Finance (Washington DC: Penn Press, 1999).

5 Economists use the word ‘capital’ to mean wealth, a factor or means of production, the value of those means of production, the net worth of a business enterprise, the present value of sequence of receipts, money, the money value of assets. The term seems to be originally economic than legal in significance. (Refer generally to, Farrar, Furey and Hanningan, Farrar’s Company Law (London: Butterworth’s, 1998) at 149; R. Sterling and K. Lemke, Maintenance of Capital: Financial versus Physical (Houston Texas: Scholars Books Co, 1981). The economists have developed many theories about capital, which is beyond the scope of this study. For example, see Adam Smith, Wealth of Nations (London: Butterworth’s, 1945) at 231.

6 The Concise Oxford Dictionary 8th (ed) (Oxford: OUP, 1990) at 136 for example, referred to ‘capital’ as: ‘stock with which company or person enters into business; accumulated wealth especially as used in further production; gain, profit from sale of investments or property…”

7 See also, R. Pennington, Pennington’s Company Law (London: Butterworth’s, 2001) at 199. The securities market term “market capitalization” refers to the amount that would have to be paid to acquire all of a company’s issued shares at their current market price.

8 It is noteworthy that the capitalization of a corporation generally includes, equity or share capital and, debt or loan capital. The term “loan capital”, as applied to a company, refers to loan funds employed by the company in its business.
1.2.1. Capital as a Trust Fund.

The Trust fund doctrine, analogous to the traditional capital maintenance doctrine, was originally formulated in the United States by Justice Story in the well-known case of Wood v Dummer. In this dividend case, the Judge equated the capital of a corporation with the property of the corporation, which was held by the corporation in trust for its creditors. In other words, the shareholders' contribution constituted a 'trust-fund' for the payment of all debts of the company.

Justice Story said:

... If the capital stock of a company is a trust fund, then it may be followed into the hands of any person having notice of the trust attaching to it ... It appears to me very clear upon general principles as well as the legislative intention, that the capital stocks to be pledged are a trust fund for payments of debts contracted by the company. The public as well as the legislature has always supposed this to be a fund appropriated for such a purpose. The individual stockholders are not liable for the debts of the company in their private capacities. The charter relieves them from personal responsibility and substitutes the capital stocks in its stead ... The stockholders have no right until all the other creditors are satisfied. They have the full benefit of all the profits made by the establishment, and cannot take any portion of the fund until all other claims on it are extinguished.

The above view was modified and applied in Appleton v Turnbull, where the court was of the opinion that it was not claimed that the property of a going solvent corporation is a trust fund for its creditors, it is only when the corporation becomes insolvent and ceases to do business that the assets become a trust fund. The Court said:

It is too firmly established at the present day to be questioned, that the capital stock of a corporation is a trust fund for the payments of its debts ... During the existence of the life of the corporation, it is a trust to be managed for the benefit of its shareholders, but in the event of a dissolution or of insolvency, it becomes a trust to the benefit of its creditors.

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9 3 Mason 309 (1824). The case was premised on the reasoning that the corporations' property is a trust fund only when the company becomes insolvent.
10 In the context of the Law of Trust, capital is conceived to be a fund of money that is invested in assets which may be varied from time to time but which, so long as they represent the original fund and until they are sold and replaced by new assets, are the property in equity for the beneficiaries of the trust. (See, R. Pennington, above n 7, 199-200).
11 3 Mason 309 at 310 (1824).
12 84 Me 72 (1824).
13 Ibid.
There is a mistaken believe that the capital of a corporation is a trust fund for the benefit of creditors which will insure them against loss from distribution to shareholders. Though to some extent the creditors are entitled to have all the property applied to the payment of debts as is the case of an insolvent individual, the fact of insolvency does not make either the property of an individual or that of a corporation a trust fund for creditors. The assets of an insolvent corporation, which have ceased to do business, are in no proper sense held by the corporation in trust for its creditors. The fact of insolvency alone does not give a court of equity jurisdiction to manage and administer the property as a trust fund and, the mere insolvency of a corporation even coupled with cessation of business has never been considered as a ground for the appointment of a receiver on the application of a creditor, unless so provided by statute.

There is also, a nominalistic confusion occasioned by the use of the term ‘capital stock’. Traditionally, most corporate statutes have regarded capital stock as synonymous to a ‘stated or legal capital’. But there seem to be a legalistic confusion in its usage and interpretation. In Harmer v Taylor Rice Engineering Co, the U.S. Supreme Court put it in the following sense:

The “capital stock” of a corporation in its merely nominal sense, is the sum specified or authorized in its charter and thereby usually divided into aliquot ... shares ... In its substantial sense, [it] is the fund of money or other property actually or potentially in its possession, derived or to be derived by it from a sale of its shares. This fund includes not only money or other property received by the corporation for shares of stock, but all balances of purchased money or installments due the corporation for shares sold by it, and all unpaid subscription for shares. The fund may through accident, shrinkage in value, or business misfortune be impaired; but subject to such contingencies, it is intended and should be equal to the par value of the nominal capital stock, which it represents.

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14 E. Hunt, “The Trust Fund Theory and Some Substitutes for it” (1903) 12 YLJ 64, 66.
15 In O’Bear Jewellery Co v Volker 106 Ala 205 (1903), the court reached a conclusion that the property of a corporation is not held by it in trust for creditors.
16 See, Uniform Corporations Act 1975(as amended), s 1(x) which provides a statutory definition of capital stock. In State v Morrison Fire Association,75 NY 211 (1932), Green J said that the phrase, ‘capital stock’ is very generally, if not universally used to designate the amount of capital to be contributed for the purposes of the corporation. Folger J there defined the term as “money or property, which is put in a single corporate fund by those who by subscription therefore become members of a corporate body”.
17 84 Fed Rep 392 (1907).
Arguably while the two terms, capital and capital stock provide a clue about the capital of a corporation, there is still little clarity as to how they may be identified. Thus, in *Smith v Dana*, the court discounted the argument that capital stock was analogous to corporate capital. One other commentator, argued that though the notion of capital stock was at one time entertained, the emphasis had shifted and capital stock was no longer thought of as something of value owned by the corporation. Jennings and Lattin in one of their earlier editions, noted that, one couldn’t point to any particular ree or fixed assets of funds as being capital or capital stock or capital assets earmarked or segregated from other assets, which are surplus.

Moreover, the right to have a debtor’s property applied to the payment of debts before being used for his own purposes does not make the debtor a trustee or the creditor a *cestui que* trust. With a trust fund, no distinction is made between the original fund, the capital with which the trust began, and the assets which now represent it because the beneficiaries have exactly the same interests in the present assets as they had in the original fund. However, with limited companies a clear distinction must be drawn between the company’s assets and its share capital, which the company has issued or may issue. Therefore, the ‘trust fund’ concept remains relevant only for historical purposes and is not a reliable indica for the modern notion of corporate capital.

### 1.2.2. Fixed and Circulating Capital.

In *Ammonia Soda v Chamberlain*, Swinfen Eady J in determining when a limited company could have paid dividends out of profits of the company, equated the word ‘capital’ to mean ‘fixed and circulating capital’. His Honour defined fixed capital and circulating capital as:

> Fixed capital is that capital which a company retains, in the shape of assets upon which the subscribed capital has been expended, and which assets themselves produce income

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18. 77 Comm 543 (1905).
20. N. D. Lattin & R.W. Jennings, *Cases and Materials on Corporations*, (Chicago: Callaghan & Co, 1979) 1110. They further posited that the courts loosely speak of the capital or property for the ultimate security of the corporation’s creditors, both present and future, rather than as a quantum, a legal limit upon which the withdrawal of its assets except so far as the net value of the property exceeds that limit.
21. [1918] 1 Ch 266 at 286,
Chapter 1  1.2. Concept of Capital

... or being retained by the company are made used to produce income or gain profits. Circulating capital is a portion of the subscribed capital of the company intended to be used by being temporarily parted with and circulating in business, in the form of money, goods or other assets, and which, or the proceeds of which, are intended to return to the company with an increment, and are intended to be used again and again, and to always return with some accretion.\(^{22}\)

The above statement is used to ascertain that the word capital indicates the assets in which the capital funds of the company have been deployed. Thus, because fixed and circulating capital follow naturally from the res theory of capital, by implication, they prohibit dividends to be paid out of capital. Yet, a company may pay dividends despite depletion in its capital assets.\(^{23}\) The rule here envisages the division of assets into two classes: fixed assets, which are permanently retained by the company and not intended for resale, and floating or circulating assets, which the company does not intend retaining.\(^{24}\)

The courts have been inconsistent and continue to face difficulties in drawing a line of demarcation as to what should be fixed or circulating capital. At one point, the courts have said that it was circulating capital which was to be maintained and not returned to shareholders\(^{25}\) but, in another instance, they made an about face and held it was the fixed capital that was to be kept intact.\(^{26}\) Since the current rule of dividends in Australian law\(^{27}\) falls short of adequately regulating dividends distribution, the concepts of fixed and circulating capital remain crude determinants in measuring a company’s viability.\(^{28}\)

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\(^{22}\) Also, in *Lee v Neuchatel Asphalt* (1889) 41 Ch D 1, to determine whether dividends could be paid regardless of past losses of the company’s assets, Lindley LJ held that the Companies Act at the time does not require the capital to be made up if lost. He said: “Fixed capital may be sunk and lost, and yet the excess of current receipts over current payments may be divided, but that, floating or circulating capital must be kept up…”

\(^{23}\) See the *Lee case* (ibid).

\(^{24}\) Although this distinction was originally economic, where Adam Smith argued that the ‘real capital’ into which both shares and loan capital is invested is divided into fixed and circulating capital, that distinction have been a topic of debate in the economic milieu.


\(^{26}\) *Ammonia Soda*, above n 21. See also, *Lee v Neuchatel Asphalt* (1889) 41 Ch D 1; *Verner v General & Commercial Investment Trust* (1894) 2 Ch 239; *Lubbock v British Bank of South America* [1892] 2 Ch 198. For a comprehensive analysis of the distinction between fixed and circulating capital refer to, Gold, “Fixed and Circulating Capital in the English Law of Dividends” (1945) 6 *To LJ* 35-41.

\(^{27}\) See, generally, *Blackburn v Industrial Equity Ltd* (1976) 2 ACLR 8 at 16; *Marra Developments Ltd v Rofe Pty Ltd* [1977] 2 NSWLR 616.

\(^{28}\) Cf *Westburn Sugar Refineries Ltd v Inland Revenue Commissioners* [1960] SLJ 297; *Blackburn* (ibid). Also, see Chapter Five of this study.
1.2.3. Capital as a Res or Quantum

Corporate capital as a res or quantum are two fundamentally opposed theories used to explain the concept of capital.\(^29\) In the Anglo-American corporate arena, courts and accountants have differed in their language between these two concepts. The theory that capital is a ‘res’ suggests a particular thing or aggregate of things, the things being the actual monies subscribed by shareholders or the actual assets in which the contributions of shareholders are invested. According to this theory, that part of capital, which must not be returned to the shareholders, is identified with the assets contributed by the shareholders in payment for their shares.\(^30\) The opposing theory that ‘capital’ is a ‘quantum’ refers to a sum of money. That sum may include a fixed receipt of assets received from shareholders.\(^31\) One other commentator, argues that ‘legal capital’ is not a ‘res’ but a ‘quantum’ or mathematical limit below which amount assets may not lawfully be withdrawn by the shareholders.\(^32\)

It is the writer’s view that both theories impact on the concept of share capital in some way. However, the res theory is far more analogous to share capital because it measures capital from the amounts subscribed by shareholders. The quantum theory relates more to the fictitious par value of shares, which has been abolished by most jurisdictions.\(^33\) That said, notions of the two theories have their individual perceived weaknesses and do not seem to play a significant role under modern corporate finance and bankruptcy laws, where the concepts of solvency or debt-to-equity ratios play a dominant role in determining the creditworthiness of a company.

\(^{29}\) N. Isaac, “Principle-Quantum or Res?” (1933) 46 IILR 776.

\(^{30}\) Gold, above n 26 (is of the opinion that the English theory of maintenance of capital adopts the res theory of capital in determining dividend distributions).

\(^{31}\) See, J.S. Ziegler, Studies in Canadian Company Law (Toronto: Butterworth’s, 1967) at 281 who took the view that the quantum theory defines capital as an abstract value of assets, however the total value may be represented at any given time. Thus, the paid up capital portion of the issue price of no par value shares. He intimated that at any given time, the company’s capital may or may not be represented by available assets, but the capital as such remains unchanged.


\(^{33}\) (This view is consistent to that of Hayek, Frederick, Pure Theory of Capital, (Chicago: Uni Chicago Press, 1975).
1.2.4 Share Capital.

The law developed certain principles relating to the raising and maintenance of capital. Where "capital" is used in relation to share capital, its precise meaning depends upon the commercial or legislative context in which it is used.34 In corporate finance law, the generic term share capital traditionally, refers to three related but distinct concepts: (1) authorized or stated capital (whose use is now redundant); (2) issued capital;36 and (3) paid up capital.37 Generally, share capital, often means the money subscribed for the shares of a company, or what is represented by that money.38 The capital subscribed as such is called ‘share capital’ rather than just ‘capital’. This is so because the Corporations Act requires that a member or person proposing to be member of a limited company and no limited liability company who has subscribed capital in the character of member or intending member should do so by acquiring the rights to be issued by the

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34 Cf Incorporated Interests Pty Ltd v FCT (1943) 67 CLR 508 at 515 per Latham CJ. Share capital is used in many different senses in accounting and legal parlance. (See, R. J. Chambers, An Accounting Thesaurus (London: Pergamon Press, (1995) 448-454). First, it can be used to refer to the value of a company’s net worth, (i.e., the difference between the value of its assets and the quantum of its liabilities). This is a representation of how much the shareholders’ stake in a company is worth at the time of the valuation. A second sense, which is now largely archaic, refers to the total value of a company’s assets. These two colloquial senses should however be distinguished from the legal & modern explication of the term.

35 A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se: Borland Trustees v Steel Brothers & Co (1901) 1 Ch 279 per Fairwell L.J. See also, IRC v Crossman [1937] A.C. 26.

36 This is determined by multiplying the number of shares which have been issued by the par or no par value of shares. It was previously used under the par value regime to indicate the aggregate of the par or nominal value of the shares that the company had issued to its members: Re Swan Brewery Co Ltd (1976) 3 ACLR 164.

37 Paid-up capital denotes that part of the par value (where there is one) or to the no par value of the issued shares, which has been paid to the company by the allottees. (Alternatively, it represents the aggregate amount that has been paid, or credited as having been paid in respect of the prices at which shares have been issued to the company’s members. The paid-up capital of a company will equate with the company’s issued capital if the company has received payment for the full issue price of all its issued shares. If part of the issue price of a share has not been paid to the issuing company, the share is partly paid-up and, that part of the unpaid shares is known as the uncalled capital. Unpaid capital includes the amount uncalled on the company’s issued shares and any amount called but unpaid on those shares. Usually, a contractual or statutory obligation is imposed on company members by its constitution to pay up any amount unpaid on the issue price of their shares. Such an obligation is enforceable while the company is a going concern by its constitution or, by a liquidator if the company is wound-up. (Generally, see, Wright v Mansell (2001) 39 ACSR 580, Corporations Act 2001 (Cth), ss 254M, 515)

38 See, for example, Ferrier v General and Commercial Investment Trust [1894] 2 Ch 239 at 265 per Lindley L.J. Writers of Ford’s Company law, define a company’s share capital as the total amount of money representing what members, or persons proposing to be members of the company, have provided or contractually bound themselves to provide to the company, in cash or other value (Ford et al, Ford’s Principles of Corporations Law, 12th (ed) (Australia: Butterworth’s, 2005) para 17.080 at 764. Corporations Act 2001 (Cth), ss 112, 254A makes provision for the different types of companies with share capital. (For example, s 112(1) stipulates that a proprietary company must be registered as either a company limited by shares or as an unlimited company with share capital; a public company can be registered as a company limited by shares or as an unlimited company with share capital. A company limited by shares is a company formed on the basis that the liability of its members is limited to the amount (if any) unpaid on their shares (s 99). Other documents providing some guidance as to what is share capital include: J. Hambrook, “Shares” in (ed), Australian Corporations Law: Principles and Practice (Australia: Butterworth’s, 2004) Vol I, Para 2.6.0005-2.6.0045
company with a share or a number of shares in that subscribed capital. The purpose of the concept of shares in the capital of a company is to facilitate distribution among members of financial benefits such as payment of dividends while the company is a going concern and distribution of surplus in a winding-up. It also facilitates allocation of member’s rights such as rights to vote at company meetings and, assists in defining the limited liability of the holders.

The doctrine of the maintenance of share capital has been applied by the courts only in relation to companies limited by shares. The doctrine is primarily intended for the protection of creditors but, it is also designed to protect shareholders present and future, against action by directors, which might covertly diminish the value of their shares as long-term investment. Initially, the common law capital maintenance provisions expressly provided that the company’s constitution shall state the amount of share capital with which the company proposes to be registered and the division thereof into shares of a fixed amount.

39 Ford et al., (Ibid). See also, Corporations Act 2001, s 117(2), s 254A. This requirement of the Corporations Act relates to limited companies by shares and unlimited companies. Traditionally, the share capital reflected a rigid yardstick fixing the minimum value of the net assets, which must be raised initially and then, so far as possible, retained in the business.

40 Ibid.


42 See, generally, Limited Liability Act 1855 (UK), s 1. This fixed amount, which was conventionally referred to as the nominal or par value, required all shares to have a par value. (See, Re Cork Bros Pty Ltd v FCT (1974) 130 CLR 124. Consequently, the par value was abolished in most jurisdictions in favour of a no par shares, which were considered by many laws, review committees as more accommodating. (For a comprehensive understanding of the arguments for and against the par and no par value shares, see, The U.K Report of the Committee of Company Law Amendment, (Cohen Committee) (1945) Cmd 6659, paras 17-189; Report of the Company Law Committee, (The Jenkins Report) (1962) Cmd 1749, paras 32-4; The Australian Company Law Securities Review Committee (CLSRC) Report No 11 on No Par Shares, (November, 1990); R. W. Dickerson, J. Howard and L. Getz, The Canadian Dickerson Committee Report, Proposals for a New Business Corporations Law for Canada (Ottawa: Information Canada, 1971) Vol 1, paras 24, 97-100; New Zealand, Company Law Reform and Restatement, Report No 9 (1989) paras 84, 376-81; Ho Yew Kee et al, "The Par Value of Shares: An Irrelevant Concept in Modern Company Law" (1990) 17 C &SLJ 30-37; Bonbright James, "The Dangers of Shares Without Par" (1924) 24 Col LR 449-477; Carlos Israel, "Problems of Par and No Par Shares: A Reprisal" (1947) 47 Col LR 1279-1300; M. Caiaus, "Shares Without Par Value" (1926) 14 Kent LJ 108, 123; C. Wickerham, "The Progress of Law on No Par Stock" (1924) 37 HLR 461, R. Raymond et al, "Shares with No Par Value" (1921) 5 Minn LR 493-514; I. Goodbar, "No Par Stocks Its Nature and Use" (1948) 3 Miami LJ 1-25.
Chapter 1  1.2. Concept of Capital

Shares now have no par value and are issued for their issued price.\textsuperscript{43} If the issue price of all shares were fully paid on allotment, no par shares would simplify allotment and accounting practices. However, if partly paid no par shares were issued, there could be difficulties in measurement. This is so in the sense that companies could issue shares in consideration for past or future services and, in some jurisdictions, there is no independent expert valuation for such partly paid shares.\textsuperscript{44}

As previously alluded to, the ‘paid up capital’ of a company represents the amount that has been paid, or credited as having been paid, in respect of the prices at which shares have been issued to the company’s members.\textsuperscript{45} At common law, it has been assumed creditors have a right to insist upon a company using its capital for the purposes of its business and not returning it to its shareholders.\textsuperscript{46} Traditionally it was assumed creditors rely upon the paid-up or uncalled capital of the company for their protection.\textsuperscript{47} It is this uncalled capital, which the capital maintenance doctrine assumes constitutes something in the nature of a guarantee fund to which creditors of the company may look. It is, in effect, an asset equivalent to ‘sundry debtors’, the debtors being the members, whose personal credit is therefore retained as an element in the concept of capital.\textsuperscript{48}

The creation of share capital generally (whether in the nature of paid-up capital, or the uncalled capital to which creditors are assumed to rely) may be important, but its efficiency as a protector of creditors’ interests has been severely undermined by the

\textsuperscript{43} The aggregate issue prices of the shares subscribed for by the first members of a company represents its issued capital on registration. (It is the total amount of consideration that a subscriber has agreed to pay the issuing company). Further capital is issued when a company gives a person title to, or control of, its shares usually by allotting them to the person pursuant to a contractual obligation, registering the person as their owner. See, National Westminster Bank plc v IRC [1990] 1 AC 119 per Lord Lloyd.

\textsuperscript{44} In Canada, partly paid issued shares have been repealed and abolished but the practice still continues in Australia. See, Corporations Act 2001, s 254A (1) (c), Australian Stock Exchange Listing Rule (ASX LR) 2.15.

\textsuperscript{45} J. Hambrook, above n 38 para 2.6.0020. The paid up capital may be regarded as a fund of credit if third parties could rely on the fact that the company had received from its member’s assets equivalent to the amount of the shares and not subsequently returned these assets or any part of them to the members. That is, they must be able to rely on the fact that the capital has actually been raised, by the transfer to the company of balancing assets and that those assets have to be maintained. (The rules laid down in the maintenance of capital in the proceeding part of this chapter) seek to ensure this reliance is not misdirected.

\textsuperscript{46} See, Re Exchange Banking Co, (Flitcroft’s case) (1882) 21 Ch D 519 at 533 per Jessel MR; Trevor v Whitworth (1887 12 App Cas 409 per Lord Herschell; Davis Investments Pty Ltd v CSD (NSW) (1958) 100 CLR 392 AT 413.

\textsuperscript{47} Ibid.

\textsuperscript{48} In Attorney General v Milford Docks Co (1893) 69 LT 453 at 556, the court intimated that the share capital of the company comprises its assets generally or, as sometimes expressed, the fund which is to pay creditors in the event of the company being wound-up.
decision of Salomon v Salomon. Its integrity has been significantly impugned by that decision because share capital failed to lift the corporate veil from a ‘one man company.’ The capital as a guarantee fund failed to apply in Salomon because a controlling shareholder was permitted to become the preferred creditor of his own company, and thus received back money which according to the capital maintenance doctrine, should have been earmarked for the protection of unsecured creditors.

The share capital machinery therefore, makes only marginal effort to protect groups or classes of shareholders from each other despite their often controlling interests. From a creditor perspective, share capital makes limited attempts to ward off three of their main worries: -erosion of the corporation’s cash flow out of which debt will be repaid, incurrence by the corporation of additional debt liabilities and creation of secured or senior debt claims. All that share capital provides is an assurance that shareholders have put something into the corporate pot and that they will not redistribute corporate assets to themselves without first protecting the creditors. Does that work at all? Though there are no systematic empirical studies, it will be argued that the statutory share capital machinery provides little or no significant protection to creditors of corporations.

1.3. The Meaning, Justification and Weaknesses of Maintenance of Capital.

1.3.1. Defining ‘maintenance of capital’.

There is no universally acceptable meaning to the phrase, ‘maintenance of capital’. Existing judicial and legislative explanations do not only remain inadequate but seem to conflict with economic understanding. The absence of a clear-cut meaning may be problematic to both the legislature and lawyer-economists when interpreting the doctrine.

49 [1897] AC 22.
50 B. Manning and J. Hanks Jr, above n 2, 91-95.
51 Judicial explanations such as provided in Trevor v Whitworth (1887) 12 App Cas 409 and in Re Exchange Banking Co (Flitcroft’s case) (1882) 21 Ch D 519 at 533 remain inadequate. In economics, the concept of maintenance of capital has as its rationale to provide a benchmark that can be used to determine whether or not income has been earned (i.e., it describes a step in the process involved in the measurement of income. (See, e.g., B. Carlsberg, “The Case for Financial Capital Maintenance” in Sterling & Lemke, above n 2, 59). See also, J. R. Grinyer and I. W. Symon, “Maintenance of Capital Intact: An Unnecessary Abstraction?” (1980) 10 Acc & BR 403-413; J. J. Forker, “Capital Maintenance Concepts, Gains from Borrowing and the Measurement of Income” (1980) 10 Acc & BR 393-401. According to these economists, the phrase, ‘maintenance of capital’ is viewed from two perspectives-financial and physical. Financial maintenance of capital regards capital as a monetary phenomenon whereby; all changes in money amount of capital are counted as income (apart from investment distribution). On
"Capital maintenance" is described in the *Company Law Review’s Strategic Framework* document as:

"[A] narrow ... and ... technical issue concerning the preservation of certain reserves which are currently designated as not normally distributable to members".\(^{52}\)

The *Oxford English Dictionary* defines the verb ‘to maintain’ as, ‘to keep up’, preserve, cause to continue in being … to keep vigorous, effective or unimpaired, to guard from loss or derogation.\(^{53}\) Armour holds the view that in accordance with this definition, one might expect the doctrine of capital maintenance to require the preservation intact of the value of the shareholders’ contribution of assets to a company (i.e., a rule requiring the ‘maintenance’ of some net asset value).\(^{54}\) To an extent, the European Union’s minimum capitalization requirement assists this goal.\(^{55}\) Arguably, however, the traditional common law capital maintenance doctrine, as developed by the courts and now reflected in the current English Companies Act and other contemporary company law statutes do not achieve preservation of net asset value.

The underlying idea of the maintenance of capital is that only profits may be distributed by the company to its shareholders whilst it is a going concern. This will ‘maintain’ the capital in the sense that where the company’s net assets are less than or equal to the amount of its capital accounts, a distribution to shareholders would deplete the assets which represent the value of the capital.


In the words of Jessel MR,

The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say gives credit to that capital, gives credit to the company on the faith of the business and he has therefore a right to say that the corporation shall keep its capital and not return it to its shareholders.  

It is for the benefit of creditors and even shareholders that share capital had to be maintained. The House of Lords preserved this principle by prohibiting corporate share repurchase and reduction of share capital in *Trevor v Whitworth*. The principle is really a negative one (‘distributions may not be made when the assets are less than the capital accounts’). It does not amount to a positive obligation on shareholders to contribute fresh assets. The maintenance of capital simply directs that capital must not be returned to shareholders. Capital in this sense, it may be argued, refers not to the assets of the company—the left hand side of the balance sheet, but to the right hand side—i.e., its liabilities. An ordinary shareholder has rights to dividends as the directors from time to time declare (whilst the company is a going concern), and should the company be wound-up, to a pro rata share of capital and profits, so long as these exceed the company’s liabilities. With this understanding, it is possible to think of capital as an indefinitely deferred claim against the company, which is payable only in winding-up, and subordinate to the claims of the company’s creditors. Accordingly, the capital maintenance doctrine seeks to ensure that the situation remains the way explained above.

The legal attitude illustrated in some old cases and legislation, is that limited liability is a privilege that obliges companies to maintain the value of capital as far as possible. Lord Watson in *Trevor v Whitworth* pointed out that:

...Persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid ... and they are entitled to

56. See, e.g., *Re Exchange Banking Co (Flitcroft’s case)* (1882) 21 Ch D 518; *Guinness v Land Corporation of Ireland* (1882) 22 Ch D 349.
57. (1887) 12 App Cas 409, at 415-432.
58. See, *Re Northern Engineering Ltd* [1994] 2 BCLC 704 at 712 per Millet J.J.
60. See, *Trevor v Whitworth* (1887) 12 App CAS 409; *Australasian Oil Exploration Ltd v Lachberg* (1958) 101 CLR 119.
assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business.\textsuperscript{61}

It might be thought from the above explanations that creditors who frequently rely on the continued survival and liquidity of the company may need some kind of capital maintenance protection. In practice however, the difficulty of making a legal assessment of the value of capital and then maintaining it, has proved to be very great.\textsuperscript{62}

1.3.2. Justification for the Traditional Capital maintenance doctrine

The central theme and policy rationale of the common law doctrine was the protection of creditors of a limited liability company from the diminution of the company's share capital either from distributions or payments to shareholders. The traditional capital maintenance rules have been reinforced by modern statutory rules redesigned to preserve a company's share capital.\textsuperscript{63}

1.3.2.1. Protection from limited liability

The capital maintenance doctrine was clearly viewed by nineteenth century judges who developed it as a means of protecting corporate creditors against risks associated with limited shareholder liability. In a famous early judgment, Jessel MR, put the matter in the following way:

The creditor, therefore I may say, gives credit to the capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he therefore has a right to say that the corporation shall keep its capital and not return it to the shareholders.\textsuperscript{64}

\textsuperscript{61} (1887) 12 App Cas 409 at 416.


\textsuperscript{63} These modern statutory rules are generally expressed in Australia thus: Dividends must only be paid out of profits and not capital (s 254T); restrictions and authorization on a company buying-back its own shares (s 257Aeff); restrictions and permissions on financial assistance by a company for the purchase of its own shares (s 260Aeff); restrictions and authorization on a company reducing its share capital (s 256eff).

\textsuperscript{64} Re Exchange Banking Company, (Flitcroft's case) (1882) 21 Ch D 518, 533-534. Jessel MR, in this case, contemplated that only profits may be distributed by a company to its shareholders whilst it is a going concern.
1.3.2.2. Preservation of a minimum of assets

The underlying idea of the traditional capital maintenance doctrine was the preservation of a minimum of assets, which envisaged protecting creditors from the risk that shareholders would subsequently withdraw their capital investment. The traditional rule was finally encapsulated in *Trevor v Whitworth* where it became the general principle of company law that a limited company’s share capital should be maintained for the protection of its creditors. There, Lord Watson in providing a rationale for the maintenance of capital explained that the law prohibits any transaction between a company and its shareholders by means of which ‘money’ already paid to the company in respect of its shares is returned to him. This was classically stated:

> Paid-up capital may be diminished or lost in the course of the company’s trading; that is a result which no legislation can prevent; but persons who deal with and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call, and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out except in the legitimate course of its business.

The above statements may be interpreted to mean that the doctrine requires a company to ‘preserve’ or ‘maintain’ its paid up capital. Under this view, it is therefore possible to understand the capital maintenance doctrine as a means of reducing the cost of post contractual opportunism by shareholders.

1.3.2.3. Restricting dividend distribution to profits.

The capital maintenance rules are justified on the grounds that their primary purpose can be achieved only if they control the extent to which any return of the company’s assets could be made to its members. A common type of distribution to shareholders is in the form of dividends. Dividends defeat the purpose of the capital maintenance rules if

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65 *Trevor v Whitworth* (1887) 12 App Cas 409 at 423.
66 Similarly, in *Guinness v Land Corporation of Ireland* (1882) 22 Ch D 349, Cotton J reiterated the preservation of a company’s shares share by holding in a dividend case that paid–up capital could not be returned to shareholders because that would take away from the fund to which the creditors have a right to look as that out of which they are to be paid.
they can be paid despite the fact that the value of the net assets of the company is, or would become as a result of the payment, less than the value of the capital yardstick of issued capital. The restrictions on dividend distribution to shareholders are justified on the grounds that if such prohibitions are not imposed, such distribution will reduce a company’s net assets, making it more exposed to the risk of default. Creditors’ interest can be harmed even if the company does not actually become insolvent. Where, in order to fund such a distribution, assets are withdrawn from valuable projects available to the company, this will result in a net social loss, as well as redistribution from creditors.\textsuperscript{69} In \textit{Ammonia Soda}, Lindley LJ intimated that:

The law, which restricts dividend payment to profits, lends support to the effect that ‘capital’ must always be kept up and be represented by assets, which if sold, would produce it …\textsuperscript{70}

\subsection*{1.3.2.4. Protection from inadequate consideration for shares.}

One of the central planks of the maintenance of capital doctrine is the rule created in \textit{Ooregum Gold Mining Co of India v Roper}\textsuperscript{71}, concerning the raising of capital and the consideration for the issue of shares. There, the judiciary and legislature\textsuperscript{72} prohibited the issuing of shares at a discount to par value. (i.e., it is unlawful for a company, except under specific statutory authority to issue any of its shares at a discount-i.e. to issue any of them as paid-up without receiving for them for full nominal value). By this, the law assumes creditors will be protected in the sense that they are provided with information about the value of the assets contributed by the shareholders to the company. There, Lord Watson stated:

The Act of 1862, (s 8(5)) requires that, in the case of a company limited by shares, the memorandum of association shall contain the amount of the capital with which it proposes to be registered, divided into shares of a certain amount. It seems to me that the system thus created by which the shareholders liability is to be limited by the amount unpaid upon his shares, renders it impossible for the company to depart from that requirement and by any expedient to arrange with their shareholders that they shall not be liable for the amount unpaid on the shares …\textsuperscript{73}

\begin{itemize}
  \item \textsuperscript{69} J. Armour, above n 2, 367. The restrictions on distribution suggest that it reduces financial agency costs by reducing the risk of default.
  \item \textsuperscript{70} Ammonia Soda Co Ltd v Chamberlain [1918] Ch 266 at 292.
  \item \textsuperscript{71} [1892] AC 125.
  \item \textsuperscript{72} See, \textit{Company’s Act 1929}, (UK), s 47; (now \textit{Companies Act 1985}, s 100). Cf with \textit{Companies Act 1958} (Vic) (now \textit{Corporations Act 2001} (Cth), s258C (Which allows companies to issue shares at a discount).
  \item \textsuperscript{73} [1892] AC 125.
\end{itemize}
Kahn-Freud described the need for such a rule in the following terms:

It is a truism that it is one of the principal purposes of all company legislation to enforce the raising and maintaining of the capital as a guarantee fund for the company’s creditors ... That every penny of the alleged issued capital of the company should be represented either by an actual payment into its coffers or by an enforceable liability of a shareholder to the company, this would seem to be one of the governing tenets of every sound system of company law. To give effect to this golden rule is a duty, which the law owes to the community. For the corporate person who has ‘no soul to be saved and no body to kicked’, the criterion of solvency must be provided by the law, which creates the persona. The criterion is the issued capital and, if that becomes a sham, the bottom is knocked out of the machinery of company.74

This rule is thought to be relevant to lending decisions and seeks to guarantee that the information is truthful.75 Would be creditors may view a company’s public documents and be misled if assets representing the share capital were never actually contributed to the company. Considerations of this sort are apparent in the reasoning of the House of Lords as Lord Halsbury stated, in laying down the rule that a company may not allot shares for less than par, “the capital is fixed and certain and every creditor of the company is entitled to look to that capital as his security.”76

1.3.2.5. Protection from undercapitalization.

The rule relating to the minimum capitalization requirement prohibits companies from incorporation or commencing business unless they have allotted capital of at least a statutory specified minimum.77 One commentator suggests that this requirement can be understood as a system of creditor protection when viewed in conjunction with the ‘expert valuation’ rules regarding the raising of capital.78 Together, they seek to ensure

75 See, E. Ferran, above 59, 283.
76 [1892] AC 125 at 133, 137.
77 The Limited Liability Act 1855 (UK), s 1 required companies which sought to be registered with limited liability status for their members, to have at least 25 members who each held at least one share of a nominal value of at least £ 10. Thus, there was an effective minimum issued capital requirement of £250. In 1977, the European Union Company Law Directive required Member States to have minimum share capital requirements for public companies (Art 6). Companies Act 1985 (UK), ss 11 & 118 which applies only to public companies, stipulate that such a company may not commence business trading unless it has a share capital of at least £50,000. Of this amount, only one-quarter needs to be paid up (s 101(11)). It is this ¼ actually paid up that represents the minimum paid-up capital. See also the case of Centros Ltd v Eksport-og Selskabstvreglen [1999] 2 CMLR 551, 586-587, in which the Danish Government sought to justify their country’s minimum capital laws on the basis inter alia, that they protect involuntary creditors.
78 E. Ferran, above 59, 317.
that at least a minimum level of assets is contributed to a public company by its shareholders, and that if for some reason the company’s net worth should subsequently fall below a ‘threshold level’, then steps should be taken to remedy the situation.\textsuperscript{79} It is also possible that rules requiring companies to carry a minimum capital may assist in correcting an externality resulting from limited shareholder liability.\textsuperscript{80}

1.3.2.6. Prohibiting companies from reducing their share capital, and from repurchasing their own shares.

To preserve the principle that a company’s share capital need to be maintained for the protection of its creditors, in \textit{Trevor v Whitworth}, the House of Lords prohibited corporate share repurchases. The House of Lords reasoned that company share repurchases would breach the principle of maintenance of capital by facilitating an unauthorized reduction of capital. The restriction was thought to be necessary because a share buy-back is assumed to diminish company funds with obvious detriment to creditors and shareholders.\textsuperscript{81} It was also assumed a prohibition on buy-back would prevent market manipulation and share support schemes in relation to takeovers. To give effect to the ban on buy-backs, Lord Macnaughten observed:

The third point is one of general importance. It raises the question whether it is competent for a company ..., on the principle of limited liability, to purchase its own shares when it is authorized by its articles to do so. The consideration of that question, as it appears to me, necessarily involves the broader question whether it is competent for a limited company under any circumstances to invest any portion of its capital to any shareholder without following the course which parliament has prescribed ... They cannot draw on a fund in which others as well as themselves are interested. That, I think, is the law, and that is the good sense of the matter.\textsuperscript{82}

\textsuperscript{79} Ibid.

\textsuperscript{80} Externalities are costs, which economic actors impose on others in such a way that those costs are not mediated by market processes. (H. B. Hansmann and, R. A. Kraakman, “Towards Unlimited Shareholder Liability for Corporate Torts: (1991) 100 YLS 1879; F. H. Easterbrook, and D. R. Fischel, The Economic Structure of Corporate Law (Boston: HUP, 1991) 60). These writers argue that by ensuring that companies have at least a certain minimum level of assets available to satisfy creditors, shareholders are prevented from undercapitalizing companies and the laws ability to correct externalities is enhanced.

\textsuperscript{81} Refer to, D. Harding, “The ICAC Proposals Regarding Purchase of a Company’s Shares” (1978) 10 C L A B 53, 53 (where it was indicated that shareholders may be adversely affected because a repurchase turns to discriminate and causes other forms of manipulative practices). See, also, Great Britain, Dep’t of Trade, The Purchase by a Company of its Own Shares, A Consultative Document (London: HMSO, 1980) Cmd 1794.

\textsuperscript{82} Trevor vWhitworth (1887) 12 App Cas 409 at 432.
His Lordship added:

It is clear from the above remarks that the thrust of the rule in *Trevor* is that shareholders, as the price paid for limited liability, cannot have their capital repaid except as expressly authorized by statute. To the creditor of the company, for whose benefit the rule was primarily established, the object or purpose for which a company has repurchased its shares makes no difference. The result is the same, namely that the shareholder received back the money subscribed and there passes into their pockets what before existed in the form of assets of the company. Assets, which might otherwise have been available for the payment of debts.\(^3\)

1.3.2.7. **Prevention of Asset-stripping Take-over.**

The prohibition on share repurchase was extended to other transactions, which, though they technically did not reduce share capital, were thought to be subject to equal or greater objection. Thus, the *Trevor rule* is accompanied by a prohibition on a company whether directly or indirectly, giving any financial assistance for the purchase or subscription of its shares or those of its holding company.\(^4\) The original rationale for the prohibition of financial assistance for the purpose of an acquisition of shares was the prevention of ‘asset-stripping’ takeovers. The Greene Committee said:

A syndicate agrees to purchase from the existing shareholders sufficient shares to control a company, the purchase money is provided by a temporary loan from a bank for a day or two, the syndicates nominees are appointed directors in place of the old board and immediately proceed to lend to the syndicate out of the company’s funds (often without security) the money required to pay off the bank. Thus in effect the company provides money for the purchase of its own shares.\(^5\)

The Committee had in mind transactions whereby a purchaser would borrow heavily to buy a majority holding of a ‘target’ company’s shares for cash, and then rapidly sell the latter’s assets, using the proceeds to discharge the loan. This can be seen as an indirect

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\(^3\) Ibid at 437.

\(^4\) Great Britain, Board of Trade, *Report of the Company Law Amendment Committee* (Greene Committee Report) (London: HMSO, 1926) Cmd 2657, para 30. The Committee asserted that for a company to provide finance to enable someone else to buy its own shares may seem to resemble a purchase by the company itself and to be similarly objectionable as reducing the company’s capital. The Committee said such a practice offended against the spirit, if not the letter, of the rules in *Trevor*.

\(^5\) Ibid. The Jenkins Committee Report also contained a clear statement of a creditor-oriented reason for banning financial assistance. (See, Jenkins Committee, above n 38, para 71). The other suggested rationale was that it is difficult for creditors and shareholders to know when a transaction decreases a company’s assets (see, D. Harding, “Section 67 of the Company’s Act—Present and Proposed Law” (1978) 10 *Com Law Ass Bull* 1, 9.
return of capital. The basic prohibitions apply to any assistance which depletes the company’s nets assets. Coupled with the Jenkins Committee remarks, the ban on financial assistance suggests that the desire to protect creditors from ‘leveraged buy-out risk’ may provide an explanation for the financial assistance restrictions.

1.3.2.8 Preservation of the ranking & risk position.

Capital maintenance rules are concerned with the priority position of creditors ranking ahead of shareholders in winding-up. They require that designated reserves should not be distributed to shareholders ahead of creditors. Seen as a company law mechanism to preserve the respective ranking and risk position of equity and debt finance, the idea that a company should maintain its capital can justify its place within the framework of positive law. The doctrine is independent of any solvency requirement with the consequence that a company cannot transfer value to shareholders by a capital distribution or cancel capital that is no longer represented by assets (with a view to resuming paying dividends in the future) without invoking the assistance of the court even in circumstances where, after the transaction, the claims of its creditors can still be met in full out of its assets and their priority position is impaired. An attempt can be made to provide a theoretical justification on the grounds that a general rule prohibiting capital distribution or other reductions of capital irrespective of the solvency of the distributing company is economically efficient since this is what creditors would bargain for in the absence of mandatory rules of company law to that effect.

1.3.3. General Criticisms of the common law share capital maintenance doctrine.

1.3.3.1. An excessive response to priority position of creditors

Though the capital maintenance rules promote the priority position of creditors’ claims to those of shareholders’ in insolvency, they do not require a company to maintain a specific

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86 Sec, Re VGM Holdings Ltd [1942] Ch 235 at 239.
89 E. Ferran, “Creditors Interest and ‘Core’ Company Law” (1999) 20 Co Law 314, 318. (“Such rules may be seen as a company law mechanism to preserve the respective ranking and risks positions of equity and debt finance”).
90 Ibid 318-319. This justification is highly questionable since it is not the law in many corporate statutes. There is also no empirical evidence to justify it.
level of assets.\footnote{E. Ferran, above n 59, 318.} The modern view of the capital maintenance doctrine goes beyond merely restating and preserving the priority position on winding up. Under English law, the principle that the designated capital funds must not be returned to shareholders ahead of creditors unless under court approval is no longer inviolate. Because the principle is independent of any solvency, it is hard to avoid the conclusion that the capital maintenance doctrine in its traditional form as a stand alone rule not linked to solvency, is an outmoded and excessive response of an earlier age to the risk that the operators of a company will engage in actions that will undermine the priority position of creditors in winding-up.\footnote{Ibid 319-320. Most modern corporate legislation, as regards corporate distributions and payments, have taken a leap from the traditional capital maintenance to an asset maintenance or solvency regime (See, for example, Australia’s Corporations Act 2001 (Cth), ss 256, 257 & 260); New Zealand’s Company’s Act 1993, s 4; Canadian Business Corporations Act 1990, s 42). However, vestiges of the old system still linger in Anglo-Australian law (see, e.g., Corporations Act, s 254T (concerning dividends) and Company’s Act 1985 (UK), s 263 relating to dividend distribution).}

Even if the capital maintenance rules do no more than preserve the respective priorities of creditors and shareholders, any acceptable and flexible rule which can permit capital distribution to shareholders or other reductions of capital that do not violate priority will depend on certain important considerations. These might include proper accounting rules that allow for the accurate measurement of solvency, suitable sanctions to deter controlling shareholders and directors from trading or pursuing financial transactions while insolvent,\footnote{The current Australian legislation, s 588G & s 588G (1A) and the English Insolvency Act 1986, s 214 offer some protection from creditor business risks by imposing liabilities on directors who allow their companies to incur debts where there were reasonable grounds to expect that the company would not be able to pay its debts as and when they become due and payable. This type of provisions partially lifts the veil available to directors because, it makes them guilty of a civil or criminal offence.} and effective rescue mechanisms where value is wrongly transferred to shareholders in priority to creditors.

1.3.3.2. Share capital provides inadequate protection.

The capital maintenance doctrine assumes that creditors rely on the share capital (or paid-up capital) for their security and protection. By so doing, it is believed that if the paid up
capital is maintained and not impaired, the company may be prosperous and creditor's debts would be satisfied. This position has rapidly changed over the years. Generally, the significance of the amount of a company's share capital on its own as opposed to its net worth or other features of its financial performance appears to be increasingly irrelevant to a decision whether to lend (or extend) credit to a particular company. Lenders significantly attach importance to cash flow or net assets and other interest cover when deciding, and if so how much, to lend to a company. The role played by share capital in lending decisions is not of primary importance to creditors. The rules of capital maintenance also appear irrelevant for the vast majority of companies which peg their share capital at such low levels that the law is likely not to place any restrictions on their dealings.

The assumption that the maintenance of share capital would suffice to protect creditors was perhaps based on the reasoning that limited companies would have an amount of share capital adequate for their business. That assumption had an initial justification in the 19th century when limited companies were associations of a large number of investors who could subscribe a huge amount of share capital. However, with the emergence of the 'one-man' type of business and the Salomon case which allowed a sole trader to incorporate with a very small amount of share capital, the traditional rationale of the capital maintenance doctrine became inadequate to protect creditors.

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94 See, e.g., Fliicorf's case, above n64; Trevor v Whitworth (1887) 12 App Cas 409.
95 Creditors do not rely on the issued share capital or paid up capital to decide whether or not to give credit to a limited company. Rather, they have adopted more prudent and sophisticated means of self protection, based on the insolvency of the company and, have relied on many considerations such as the integrity, soundness and future prospects of a customer's business and security in lending decisions (refer, to P. Lipton & Herzberg, *Understanding Company Law*, 11th (ed) (Sydney: Law Book Co, 2003) at 102.
97 The maintenance of capital rules focus on the status of an entry in the accounts based on the amounts contributed by those whom the company has allotted shares. It is highly unlikely that under ideal contracting conditions, creditors would place much emphasis on reaching agreements with borrowers on such matter as share capital (See, B. Cheffins, *Company Law: Theory and Structure and Operation* (New-York: OUP, 1997) 529-30.
99 Ibid, See also, generally, R. Pennington, *Pennington's Company Law*, 8th (ed) (1995) 187 ("A creditor who inquires into the company's resources before allowing it to become indebted to him does not in practice rely on the amount of the company's share capital, paid or unpaid, in assessing its credit worthiness"); Manning & Hank, above n 2, 92 ("A Corporation's legal capital is a wholly arbitrary number, unrelated in any way to any economic facts that are relevant to a creditors"); Great Britain, (DTI) Company Law Review Steering Group("CLRSG"), "Company Formation and Capital Maintenance" (1999) at 23-24 ("The view of a substantial number of
that creditors would be more interested in the level of the company’s share capital proved false. The primary reason that creditors do not give significant weight to share capital is that as soon as a company commences operation, it can use its capital to purchase assets that decline in value. Creditors are more interested in a company’s ability to pay its debts as they fall due. Even a company with a token share capital could have cash flow, making it credit worthy.\textsuperscript{100} The share capital entry on the right-hand side of a company’s balance sheet provides no useful information to creditors.\textsuperscript{101}

Ferran also argues that the share capital maintenance doctrine assumes, falsely, that the fixed amount of a company’s share capital informs current and potential creditors of the resources that a company possesses and may not freely distribute to its shareholders.\textsuperscript{102} In the traditional view, capital maintenance provisions protect potential creditors against deceit by restraining companies from misrepresenting their real capital. However, the law provides general remedies against misrepresentation.\textsuperscript{103} She contends that, the possibility that a company will mislead creditors as to its real capital depends on the existing legal regime.

If a jurisdiction adopts harsh legal capital rules, creditors will have a reason to believe that shareholders indeed contributed a specific amount of capital. But if a jurisdiction has not adopted such rules, creditors will not rely on the share capital figures. They will allow for the higher probability that shareholders have not in fact made contribution of that amount, and behave accordingly by further investigating the availability of a satisfactory

\textsuperscript{100} Ford et al, above n 34, 886.

\textsuperscript{101} See, e.g., T.L. Blackburn, “The Unification of Corporate Laws: The United States, the European Community and the Race to Laxity” (1994) 3 Geo Mason Indep LR 1, 81, (“The legal capital of a company express only historical facts concerning the company and do not give any significant indication of the current financial condition of the company”); B. Cheffins, \textit{Company Law, Theory, Structure and Practice} (1997) 5333-534 (“Creditors concerned prospectively with the risk that a company might divert assets have several options. They may require a company to comply with a solvency requirement and a specific financial ratio, like the debt-to-equity ratio and current ratio”); J. Keustermans, “Countertrends in Financial Provisions for the protection of Corporate Creditors: The MBCA & EEC Corporate Directives”(1986) 14 \textit{DENU J Int’l Law & Policy} 275, 288 (“The share capital is irrelevant because creditors can protect themselves by imposing liability on directors through wrongful trading provisions, they may charge a higher interest rate that compensate them for their risks, they may insists upon collaterals of some kind, they may contract on specific contractual restrictions on distributions such as loan covenant”).

\textsuperscript{102} E. Ferran, above n 89 at 283.

\textsuperscript{103} Ibid.
Chapter 1  

1.3. Justification & Criticisms

equity cushion. In any case, it is far from clear why creditors should care whether shareholders contributed more or less at the beginning of the venture. In the real world, creditors (and potential creditors) care neither about share capital resources nor about the capital maintenance rules that are supposed to signal these resources.\textsuperscript{104}

1.3.3. Capital maintenance doctrine is not a capital adequacy requirement.

Some lawyer-economists, who have evaluated the capital maintenance rules from a capital adequacy and risk capital perspective, have argued that they are not capital adequacy requirements.\textsuperscript{105} The rules do not require a limited company to maintain a specific level of net assets like banks do in accordance with their prudential regulation. Thus, the controllers of a company can invest all of the capital raised through share issues in risky assets (i.e., they can lend it to a borrower with a poor credit rating) without in any way infringing the maintenance of capital doctrine.\textsuperscript{106} Although section 142\textsuperscript{107} and other statutory provisions of some European States which impose the ‘recapitalize’ and ‘liquidation’ rules attempt something approaching a capital adequacy requirement, they rarely apply effectively.

\textsuperscript{104} Ibid 284-285; B. Manning and J. Hank Jr, above n 2, 92.


\textsuperscript{107} Companies Act 1985(U.K.), s 142 is a curious provision which directs the directors of a public company which has suffered a serious loss of capital (i.e., its net assets are half or less of its called up share capital), to call an extraordinary meeting to consider what steps to take so as address the problem.

The recapitalize and liquidation rules are statutory measures implemented in Sweden and France, whereby if for any reason the company’s net worth should subsequently fall below a threshold level, the company directors must take steps to either recapitalize or reorganize into a type of company with a share capital no greater than the remaining net assets. If the company fails to implement such steps timeously, these rules require the company to be wound-up, or personal liabilities are imposed on the directors. (Refer generally to, Wyneener, “Centros: A Landmark Decision in European Co Law” in T. Baum, K. Hopf & N. Horn, (ed) Corporations, Capital Markets and Business in the Law (2000) 628-629; L. Enrique’s and J. Macy, “Creditors versus Capital Formation: The Case against the European Legal Capital Rules” (2001) 86 Cornell L R 1165, 1167).
1.3.3.4. The doctrine imposes substantial costs on companies.

Enrique and Macey argue that the capital maintenance rules are not beneficial since they impose much substantial cost on companies. The rules are costly in terms of time and money thereby burdening shareholders and creditors, which these rules supposedly protect.\(^{109}\) This is particularly obvious when the rules require shareholders to make contributions in kind in exchange for shares and to pay for independent expert reports as required by the current English capital maintenance provisions.\(^{110}\) The minimum capitalization requirements are costly in that they delay company formation. The requirement for authorized distribution and payments to shareholders to be sanctioned by the courts entails much time and much litigation cost.

Also, the prohibition on share repurchases may increase the cost and likelihood of disputes among shareholders. In most cases, the prohibition will prevent a company from purchasing the shares of a dissenting shareholder, making it more difficult to overcome deadlock or disharmony, which may negatively affect the company’s operation.\(^ {111}\) Share capital rules also impose costs on some creditors, especially ‘weak’ creditors. If a company, for example, is a monopolist in the market for its products, then shareholders will be able to pass the cost of the capital maintenance rules onto the consumers. If such companies are able to pass the costs of the business to counter-parties with whom they have greater bargaining power, then it is precisely the creditors that the capital maintenance rules supposedly protect who will bear the costs.\(^ {112}\)

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\(^{109}\) Enrique’s and Macey, (Ibid). A similar argument was advanced by F. Kubler, “The Rules on Capital under the Pressure of the Securities Markets” (2000) at 13 (Unpublished Manuscript, on file with the author).

\(^{110}\) See, Companies Act 1985 (UK), ss 103 and 108 (requiring independent expert valuation for non cash consideration of shares). The writer does not see this criticism to be too sound. This is because, though an valuation to shares than the alternative ‘directors honest estimate test’ applied in other jurisdictions. (See, the position in Australia). For more on this issue, see, Chapter Seven (below) concerning the rule on consideration.

\(^{111}\) Cf. R. O. Kummer, “State Statutory Restrictions on Financial Distributions by Corporations to Shareholders” (1984) 59 Wash LR 185, 207-08 (“Observing that if a company chooses not to repurchase shares from a shareholder who wishes to leave the company, conflict may later develop between management and that shareholder”).

\(^{112}\) Cf. F. Kubler, above n 109, 13 (“Arguing that rules on maintenance of capital operate as a restriction of the freedom to contract, as they burden all creditors with risk-reducing costs which at least some creditors would prefer to avoid in order to bargain for a higher return”). Some creditors, however, would prefer to bear a higher risk of default in exchange for a higher return on their investment. Thus, the capital maintenance rules benefit risk averse lenders (like banks) that prefer low-risk and lower returns investments, not risk-prefering capital providers like finance companies, private equity investors, or venture capitalists that prefer higher-risk investments because of the higher return associated with such investments.
1.3.3.5. The broad prohibitions on share capital transactions are irrelevant.

The very broad prohibition on financial assistance for the purchase of a company’s shares unduly restricts shareholders’ and directors’ freedom to manage companies. On the one hand, the prohibition’s benefits are doubtful because it can only protect the interest of creditors in a situation of potential insolvency, when the directors’ duties and the provisions on wrongful trading are likely to be relevant. On the other hand, the doubts that the capital maintenance rules raise on the legality of leveraged buy-outs may have a negative effect on the functioning of the market for control. Some other critiques argue that in the light of other more clearly targeted regulatory measures and creditors’ greater sophistication, the wider scope of the financial assistance rules are becoming irrelevant.

A further argument against the prohibition of share-buy-back and financial assistance is that they facilitate employee stock option plans and improve earnings per share by reducing the number of shares and increasing the ratio of debt to equity financing. Barret argues that creditors will not be prejudiced if a company gives financial assistance in relation to an acquisition of its shares, nor will financial assistance cause a diminution in the financial position of the company. Illustrating with a hypothetical example he said:

If [A] had no ready cash with which to buy shares, but owned a valuable asset, which could be used by the company in its business, the company could legitimately buy the assets for a commercially realistic price and thereby provide the money that would assist [A] financially in his purchase. According to the common law, that would be a breach of the financial assistance law. To my mind, there is no breach because, that is a commercially acceptable transaction and, to prohibit it would prevent useful management buy-outs from being realized.


115 I. Pollard, “Trends in Corporate Finance” (June 1981) Sessional Meetings, Institute of Australian Actuaries at 17. Another argument against the ban on financial assistance is that where a company provides financial assistance to purchase its own shares by an outsider, this will not harm creditors and shareholders if the loan is well secured and returning a high rate of interest to the company.

More generally, the restrictions on share repurchases, makes equity investments less liquid, and hence less attractive ex ante because, reselling shares to the company may often be the only way for shareholders to liquidate their investment in a tight market. Moreover, the principle, which prohibits companies from either redeeming or repurchasing their own shares, has been rendered ineffective in some jurisdictions that focus on the narrow exceptions rather than the worth of the prohibition on corporate transactions. In Australia, for example, prior to the introduction of the law on indirect acquisition, companies were able to use a legal ‘back-door’ indirect avoidance mechanism, the “Poseidon approach” to establish protective cross shareholdings between companies. This was useful in supporting existing management and as a defensive tactic in takeover.

1.3.3.6. Minimum paid-in capital requirement provides an illusory protection

The rule mandating public and private companies in the European community to be formed with a minimum paid in capital requirement may be understood as a crude means of protecting involuntary creditors from the use of limited liability companies and, as an easy judgment-proofing strategy for those conducting hazardous activities. However, it is argued that the more a minimum capital is used as a means of preventing judgment proofing (i.e., the higher it is set), the more restrictive it will be on company’s ability to make use of limited liability. If this were the only technique available for internalizing the costs which ‘judgment-proofing’ may impose on involuntary creditors, then one

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117 See, Corporations Act 2001 (Cth), s 259 C & D.
118 August Investments v Poseidon & Samin Ltd (1971) 2 SASR 71. Contra ss 259C & 259D (These sections make the Poseidon mechanism no longer applicable in Australia).
120 J. Armour, above n 2 at 355, 378. The Jenkins Committee, has also doubted the rationale for the minimum capitalization requirement when it stated: “...it would be difficult, if not impossible, to prevent a company, once formed with a statutory minimum of cash, from returning the cash to the promoters as payment for future services. Although we would favour in principle a statutory minimum paid-up capital, we have reluctantly come to the conclusion that its purpose would be too easy to evade and we cannot therefore recommend it”: (1962) 7, Presumably, the Committee is quite correct because the integrity of a minimum paid-in capital may be impugned by the exchange of shares for intangible consideration such as goodwill and future services.
would have cause for a detailed enquiry into their costs and benefits. In some jurisdictions, there is no requirement that a company must have a minimum paid-up share capital and as such, companies can commence business with as little as $2 making the capital inadequate from the onset yet, creditors are still protected through other alternatives.\(^{121}\) There are a variety of more finely tuned regulatory techniques to be adopted such as mandatory ‘guarantee fund’ or even a mandatory insurance policy.\(^{122}\)

1.3.3.7. The ‘No discount rule’ may be misleading

The common law capital maintenance rules which, for example, prohibit the discounting of shares,\(^{123}\) have been criticized for not being a practical source of protection for creditors. The common law has failed to adequately control the issue of shares for ‘colourable’ consideration.\(^{124}\) Gower, in one of his earlier texts, points out the supposed weaknesses:\(^{125}\)

- There is no requirement that shares must be of a reasonable nominal value and that part of this value must be left uncalled. Hence the practice is to have shares of low denomination issued fully paid on allotment. Uncalled capital, which was envisaged as the main protection of the creditor has virtually disappeared, thus removing any element of personal credit from the concept of capital.\(^{126}\)
- Since shares may be issued for either cash or non-cash consideration, and since the courts will not normally investigate the adequacy of the consideration, there is not even any assurance that the company ever received assets equivalent to the nominal value of its issued capital.\(^{127}\)

1.3.3.8 The dividend restriction inhibits signaling function of dividend policy.

The capital maintenance doctrine assumes that creditors are protected if dividends are paid only out of distributable profits. At most the law prevents an open return of capital.

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\(^{121}\) For example, see, Australia’s Corporation’s Act 2001 (Cth). Even in the U.K. where there is a minimum paid up capital requirement (public companies), private limited companies are not required to have any minimum capital requirement and creditors of such companies are protected by other means other than a minimum capitalization requirement.

\(^{122}\) See, the arguments for and against a minimum paid-up capital in Chapter 6 of this study. See, also, J. Armour, above n 2, 102, 378.

\(^{123}\) Ooregun Gold Mining of India v Roper [1892] AC 125

\(^{124}\) The issue as to colourable consideration for shares is somehow addressed under the current English Companies Act 1985, ss 103 & 108 requiring an independent expert valuation for non-cash consideration.


\(^{126}\) This criticism is obviously enough, because there is apparently no need for companies to have uncalled capital when they can commence business with a paid up capital as little as $2.

\(^{127}\) Cf Ooregun Gold Mining Co of India v Roper [1892] AC 125, Re Wragg Ltd [1897] 1 Ch 796.
Chapter 1

1.3. Justification & Criticisms

It has not been effective in preventing payment of dividends until past losses have been recouped. The restriction of dividends to profits inhibits the signaling function of dividend policy. This limitation reduces the ability of the market to process information on dividend policy, and has a negative effect on the equity market’s efficiency and, consequently on the liquidity of shares.\(^{128}\) There can be little doubt that this is the most dramatic weakness associated with the maintenance of capital. Share capital will be very often totally dissipated by companies, which are lawfully able to pay out dividends without first having to make up losses from previous accounting periods.\(^{129}\) However, the current English provision that dividends be paid out of distributable profits has revolutionized that position by the enactment of s 263 defining the conditions under which a sum representing a revaluation of assets may be treated as realized profit. Accordingly, if the distribution is to be made there must be an accumulated profit and past losses must be made good. As such, the incongruous and perhaps damaging Australian common law principles outlined in *Marra Development*, no longer apply in the UK.

1.3.3.9. **Capital maintenance rules are inadequate on efficiency grounds.**

It is further argued that, even if one assumes, that capital maintenance rules do significantly benefit weaker creditors; there is no reason for legislation to adopt them because if these rules were adequate, the market would adopt them spontaneously.\(^{130}\) A company could grant such protection to its weakest creditors, as long as these creditors value the benefits of such protection more than its cost to the company.\(^{131}\) Some commentators posit that legal capital rules are market-mimicking devices that save parties from incurring transaction costs.\(^{132}\) The common law rules are however ineffective because not all companies benefit from them.

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128 D. Fischel, *The Law and Economics of Dividend Policy* (1981) 67 Va LR 699, 708-709. ("Dividend policy is an efficient signal that management can use to convey inside information about the firm’s cash flow"). See also, E. Ferran, *Company Law and Corporate Finance* (Britain: OUP, 1999) at 410-411 ("Dividends can perform an information function, by indicating that management has confidence in the business and its prospects").

129 See, *Marra Developments Ltd v BW Roje Pty Ltd* [1977] 2 NSWLR 616; *Ammonia Soda Co Ltd v Chamberlain* (1917) 1 Ch 266.

130 See generally, J. Armour, above n 2, 263; E. Ferran (Ibid). (Both literature discussing efficiency).

131 Ibid.

132 Ibid. It was previously argued that the share capital rules imposed much costs on creditors. Therefore, it might be difficult to see how the rules reduce cost.
As such, the demands for maintenance of capital rules are certainly not strong enough on efficiency grounds nor, are they justifiable on the grounds that they are market mimicking.\footnote{Ibid. There is little empirical study to really determine whether the capital maintenance rules are ineffective on market or efficiency grounds.}{133

1.4. Conclusion.

This general analysis reveals some merits but also, serious weaknesses associated with the maintenance of capital doctrine. In practice, the difficulty of making a legal assessment of the value of share capital and maintaining it has proved to be very great. The study also shows that many lawyer-economists do not support the capital maintenance doctrine as a basis for practical creditor protection. The need for the maintenance of the share capital doctrine is therefore placed in doubt. It is suggested creditors would benefit most from alterative measures. Nonetheless, it is worth drawing together a few tentative propositions to summarize what is gleaned from the positive and negative arguments about the maintenance of capital.

- The rules of share capital appear to be irrelevant for a significant majority of Anglo-Australian companies, which peg their share capital at such low levels that the law is likely not to place any restrictions on their dealings.\footnote{Even if the company had a large amount of paid-up capital, a creditor would be unable to assess financial risk if the company substantially relied on debt financing, especially secured finance. (See, generally, J. Payne, “Company Capital: The Need for Reform” (2000) 21 Co Law 62, 63, E. Ferran, above n 105).}{134

- Share capital cannot usually be measured with a reasonable expectation of accuracy and therefore, cannot adequately protect creditors.

- Following the above, the retention necessary to achieve maintenance of capital cannot be identified in any precise and objective manner

- Absolute prohibitions on buy-back, reduction of capital, financial assistance and dividend distribution may be too restrictive and may hinder commercially viable investment projects.

- Empirical studies suggest that the role played by share capital in lending decisions may be irrelevant since it is not a factor of primary importance to creditors.\footnote{A. J. Berry, S. Faulkner, M. Hughes and R. Jarvis, “Financial Information, the Banker and the Small Business” (1993) 25 Br Acc Rev 131-150; D. Dealton and G. Hussain, “Financial Information, the Banker and the Small Business: A Comment” (1994) 26 Br Acc Rev 323-335.}{135

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Theoretical and empirical studies suggest that creditors base their lending on the creditworthiness and financial viability of the company based on its cash flow and balance sheet solvency. Another possible explanation is that in the U.S. where the share capital maintenance is not deeply rooted, creditors habitually include loan covenants in large scale lending agreements, which restrict distributions and payments to shareholders.  

- It is far from clear as to whether the rules restricting dividend distribution on profits and those requiring companies to carry a minimum paid in capital have much basis in efficiency.

The deficiencies in the doctrine, might suggest that there is a real need to abolish or repeal it. However, the doctrine will continue to play an important role to investors and the capital market. Developments in the financial and investment market and more sophisticated means of creditor protection suggest there is an apparent need to strengthened and improve the existing capital maintenance rules designed in protecting corporate stakeholders.

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138 See Chapter 8 of this study where the recommendations and future position of the doctrine is canvassed. The writer is of the view that the maintenance of capital doctrine in its traditional form remains highly questionable and is a mirage-like abstraction. However, contemporary statutes have significantly make improvements on the various rules, there is not much need to abandon the doctrine but, to strengthen it.
CHAPTER TWO
SHARE BUY-BACKS

2.1. Introduction.

One of the ways by which a company may return share capital to its shareholders is when it buys-back its own shares. Traditionally, this method of returning capital to members was prohibited under the capital maintenance doctrine on the assumption that it would be prejudicial to creditors. This assumption has been subject to criticism. The maintenance of capital doctrine has been significantly relaxed in recent times in Anglo-American jurisdictions, to the effect that limited companies can now buy-back their own shares coupled with safeguards intended to protect creditors and the public. However, a review of the current provisions in Australia, underpinning the regulation of buy-back and the mechanisms for the protection of creditors and shareholders suggests that apparent lacunae still exist in the law. The aims and objectives of this chapter are manifold. First, it will demonstrate in the historical framework that although companies were traditionally prohibited from buying-back their own shares based on the concepts of share capital and the par value regime, sound commercial justifications for buy-backs resulted in the ban being relaxed in subsequent years in both Australia and the United Kingdom. It will further illustrate that though the

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1 The term, ‘buy-back’ or ‘repurchase’ is used to describe a transaction in which a company purchases its own shares. The Corporations Act 2001 (Cth), s 9 states that a buy-back means the acquisition by a company of shares in itself. In this Chapter, the various words, ‘buy-back,’ ‘repurchase,’ ‘self-purchase,’ will be used interchangeably.

2 Trevor v Whitworth (1887) 12 App Cas 409, 423 (per Lord Watson).

two jurisdictions significant relaxed their laws on buy-back, Australia took a leap from the UK by not only abandoning the par value regime but also, allowing Australian companies to buy-back their own shares without relying much on whether share capital was maintained for the protection of creditors but on whether the company would be able to pay its debts as they become due after the buy-back transaction.\textsuperscript{4} Thirdly, the chapter will seek to demonstrate the different types of share buy-backs and procedures undertaken in Australia and the U.K and to highlight certain weaknesses in the various types of buy-backs. The chapter evaluates whether a company should cancel its own shares after being bought-back or, whether to reissue them as treasury shares. Finally, the chapter has as its objective to examine how the current buy-back regime in Australia protects creditors and shareholders from buy-back transactions which may have a detrimental effect on their interest. Sections 2.2 traces the history of the legislation in Anglo-Australian law. Section 2.3 analyses the current methods and procedures of buy-back in Australia. The last parts, section 2.4 examines some policy issues, and 2.5, evaluates the mechanisms for creditor and shareholder protection.

2.2. History of the Legislation

This part of the chapter traces the legislative history of share buy-backs in Anglo-Australian jurisdictions following a certain time frame. The legislative history has as its objective to show that traditionally buy-backs were prohibited by the common law based on the concept of par value, ultra vires doctrine and maintenance of share capital. That Australia’s buy-back laws were modeled on the English law without much enquiry as to its desirability for Australian companies. It also shows how in later years, with the demise of both the par value and the ultra vires doctrines in contemporary statutes in favour of a no par value regime, both the English and the Australians relaxed the prohibition on buy-back, but with each developing its own types of buy-backs using different regulatory means to protect creditors and shareholders.

\textsuperscript{4} Reliance on this safety net was based on a cash-flow solvency test. (See the discussion on creditor protection in section 2.5 (below), and the analysis in Chapter 8 of this study relating to optimum means of protecting creditors from share capital transactions. Directors of the company were also subjected to stringent liabilities if they authorise a company to buy-back its own shares whilst insolvent.
Chapter 2.  

2.2. History of Legislation (English).

The effect of the legislative history is that while the UK currently allows companies to buy-back their own shares, it preserved vestiges of the par value regime and the maintenance of share capital doctrine in protecting its corporate stakeholders. On the other hand, Australia abandoned the concept of par value and relaxed its reliance on share capital in favour of a no par value regime and a cash flow solvency requirement fenced with greater director responsibility. Finally, the history of the legislation is important to the theme of the study in that it mirrors the arguments in chapter one of this study relating to the concept of capital. It will demonstrate that traditionally buy-backs were prohibited and initially considered important in protecting creditors. However, that has significantly changed profoundly. Now, the laws of most contemporary statutes facilitate buy-backs by illustrating that creditors do not rely on share capital for their protection, but, on alternative means of protection other than on the maintenance of capital. The history also provides the benchmark for the concluding remarks which show a shift in emphases from buy-backs reducing a company’s capital to whether buy-backs would render the company insolvent and unable to pay its debts as they mature.

2.2.1. English History

The first case to cast doubt on the power of a company to purchase its own shares was *Droitwich Patent Salt Co Ltd v Curzon*. However, dicta to the effect that companies possessed such a power were to be found in *Teasdale’s case* where, James LJ held that:

There is no doubt that a company may give itself power to purchase its own shares, to take surrenders of shares and to cancel the certificates of shares ...We cannot introduce a new principle of law in order to benefit the creditors of the company.

In *Hope v International Financial Society*, James LJ, seemed to have made an about face when he remarked:

I am reported to have said in *Teasdale* that the power to purchase shares would be good. I am not quite sure whether that was not too wide a declaration from the cases to which I was then referring, and certainly, that was not necessary for the decision.

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5. (1867) L.R 3 Eq 35. The case concerned a company formed originally under a deed of settlement which gave the company power to reduce its capital. An attempt by the company to reduce its capital under the 1862 Act was held to be invalid. Cf, *Hope v International Finance Society* (1876) 4 Ch D 327, 336, which lead to the enactment of the 1867 Act conferring on companies the power to reduce capital subject to a court sanction.


7. (1876) 4 Ch D 327, 336.
But in *Re Dronefield Silkstone Coal Co*, 8 Jessel MR, at first instance, ruled that a clause in a company's articles, giving the power to repurchase its own shares was invalid. Cotton LJ reversed the decision on appeal, by holding that such a power was not prohibited by law and therefore did not involve a reduction of capital. 9 Influenced by the principle of limited liability, and by the *Company Acts of 1867-1877*, which provided for a comprehensive procedure for a reduction of capital, the House of Lords in *Trevor v Whitworth*, 10 overruled *Re Dronefield* and established an absolute prohibition against companies repurchasing their own shares.

In *Trevor*, a company whose objects were to carry on a flannel manufacturing business and other businesses and transactions which the company might consider to be in any way conducive or auxiliary thereto, had in its articles a provision empowering it to utilize its funds to purchase its own shares. The company having gone into liquidation, a former shareholder made a claim against the liquidator for the balance of the purchase price of the company's shares sold by him to the company before the liquidation. The claim was allowed in the Court of Appeal under the principles laid down in *Re Dronefield*. However, the House of Lords held that such a repurchase was void. 11

Two distinct lines of reasoning were employed in the *Trevor rule*. The first rested on the fact that the company's memorandum contained no express power to repurchase shares.

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8 (1881) 17 Ch D 76, 93. There, the company's memorandum of association contained a clause authorizing the doing of things which the company considered conducive to the company's objects. The articles authorized directors to buy-back shares. The company was prosperous and solvent but, later felt into difficulties and was wound-up.

9 Cotton LJ said:

> Now, I agree with the Master of the Rolls that nothing contained in the articles can make a trafficking in shares legal if the memorandum does not authorize it. Whether it would be legal if the memorandum did authorize it, I do not think it necessary to give any opinion. (Ibid at 94).

10 (1887) 12 App Cas 409. The rationale for the prohibition on buy-backs was predicated upon the ground that such action produced special injury to creditors. It also sprang from the necessity of imposing safeguards against the depletion by a corporation of its assets and the impairment of its capital needed for the protection of creditors. Contra, a line of American cases which digress from the *Trevor rule* (see, *Ex parte Holmes*, 5 Cow 426, NY 434 (1826); *Hartidge v Rockwell*, RM Chart 260 [1828]; *Dupree v Boston Water Power Co*, 114 Mass 37 (1873); *Copper Belle Mine Co v Castello*, 11 Ariz 334 (1908); *Hughes v Northern Elec & Mfg*, 50 SCR 626 (1915); *Sciggins v Thomas Dalby Co*, 290 Mass 414 (1935); cf the criticism of Hand J, in *Re Trichereor-Ground Co*, 203 F 720, 721 (1917) (who rather, favoured the English rule). For a better comparison between the 'English and American rules' see, A. Trichardt, K. Organ & Cilliers, "Purchase by a Company of its own Shares: English Rule V American Rule" (1989) 10 *Trans CBL* 37.

11 See the views of Lords Herschell, Watson, Fitzgerald and Macnaughten (*Trevor v Whitworth*, (1887) 12 App Cas 409 at 423).
Chapter 2.  2.2. History of Legislation (English).

(though the articles laid down procedures for making such repurchases). It was therefore said that the ‘trafficking’ in its own shares could never be a legitimate object of the company, and therefore, any purported repurchases were ultra vires and void under the 1862 Act. Such a view accorded perfectly well with the very strict rule on ultra vires contracts which the House of Lords had adopted 12 years previously in *Ashbury Railway Carriage & Iron Co Ltd v Riche.* However, the steady decline in the ultra vires doctrine has diminished the weight of this line of argument in the debate about buy-backs. The other general reason taken by the House of Lords, based on policy grounds, was that a company cannot repurchase its shares at all, since it does so either to reduce its capital, which goes against the principle that the capital is available as a permanent fund for creditors, or to traffic in its shares, which was regarded as inherently unlawful. Lord Watson in introducing and formulating the rules governing the maintenance of share capital by a company in *Trevor v Whitworth* stated:

Paid up capital may be diminished or lost in the company’s trading, that is a result which no legislation can prevent; but persons who deal with, and give credit to, a limited company naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffer of the company has been subsequently paid out, except in the legitimate course of its business.

This general rule became deeply rooted in the common law and many corporate statutes in jurisdictions modeled on the English legislation. The rule established in *Trevor v Whitworth,* which came to be universally known as the *Capital Maintenance Doctrine,*

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12 Ibid. per Lord Macnaughten at 424.
13 (1875) LR 7 HL 653.
14 See, for example, *Corporations Act 2001* (Cth), s 125(1) which has rendered obsolete the ultra vires doctrine.
15 (1887) 12 App Cas 405, 425; 437 (per Lords Watson and Macnaughten). In considering the decision in this case one has to bear in mind that the principle of limited liability was still a novel concept and the ghost of the so called ‘South Sea Bubble’, a financial scandal in which the limited liability of a company had been used for fraudulent purposes, was still prominent in English jurisprudence. With this background, one can readily understand the consternation of their lordships at such transactions.
16 (1887) 12 App Cas 409, 423-424. This doctrine was formulated in case law in the nineteenth century for the protection of creditors because, in the words of Jessel M.R:

The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business and he has therefore a right to say that the corporation shall keep its capital and not return it to its shareholders .... *Re Exchange Banking Co ("Fitzcroft’s case")* (1882) 21 Ch D 519, 533.
17 The term, ‘capital maintenance doctrine’, is sometimes also referred to by company text writers and commentators as the “English rule” or the “Trevor rule.” The principal rationale that creditors rely on the maintenance of its paid
states that the issued or paid-up share capital of a company forms a fund available to the creditors of the company to meet their legitimate claims against the company. It is therefore not to be dissipated by the company, nor must it be returned to the shareholders, whether in the form of dividends or otherwise. Its principal rationale was therefore centered on the protection of the creditors of the company who were entitled to rely on its paid-up capital as a source of funds to which they could look for payment. But the rule also provides a basis for protection of the shareholders of a company especially those in a minority position, since the prohibition of a company’s purchase of its own shares prevents directors from authorizing a purchase in order to maintain control, or to remove a troublesome shareholder.

Arguably, the Trevor doctrine was attractive in the 19th century, when courts were still working out their attitudes to limited liability companies, and when the general view was that the activities of companies needed to be severely controlled. However, the traditional nature of the doctrine is now difficult to accept as a practical reality. Companies commonly use their share capital, in conjunction with their other assets and funds, for purposes of operating the business. It does not follow that the company is being mismanaged, or that creditors are necessarily prejudiced. While the rule gained ground for a very long time, as will be seen, strict adherence to it eventually came to be seen as inconvenient, not least in small companies, where repurchase of company shares is often seen as the best way of buying out a shareholder who wishes to leave.

The Trevor rule became the authority for a string of common law decisions and subsequent statutory enactments. However, it was later recognized that the rigid application of the principle might be unduly restrictive and thus over the years there has been created an entanglement of legislative prohibitions and ad hoc exceptions.

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18 This attitude may be regarded as being responsible for the decision in Ashbury Railway Carriage, above n 13. ("Ultra vires contracts void").
20 See, for example, Hope v International Finance Society (1876) 4 Ch D 327; Ooregum Gold Mining Co of India v Roper [1892] AC 125; Re Federal Bank of Australia Ltd (1894) 20 VLR 199.
An apparent exception to this common law rule arose in Kirby v Wilkins. There, it was held that the prohibition did not preclude a company from taking a voluntary transfer of its own shares, which were held by trustees on its behalf. Accordingly, there was nothing preventing fully paid shares in a limited company from being transferred to a person to hold as nominee for the company, as long as the company itself did not provide any consideration for the transfer. The capital fund was believed to be protected in the sense that only profits could be used to redeem the redeemable preference shares.

The above decision led to the 1926 Greene Committee recommending that provisions for redeemable preference shares be introduced. According to the Report, "such provisions would prove useful, and provided that proper safeguards are adopted, we see no reason why this power should not be given." The Committee stated:

> Where redemption is effected out of profits it should be limited to the amount of undistributed profits available for dividends and there should be transferred to a permanent reserve a sum equivalent to the amount applied in redemption of preference shares...

This recommendation was adopted, allowing companies to issue and redeem a special class of shares on the condition that these should not be equity shares.

The previous section was reenacted as s 58(1) of the Companies Act 1948 and, the decision arrived at in Kirby was confirmed in Re Castiglione's Will Trusts. According to s 58, if shares were redeemed out of profits, an amount equivalent to the nominal amount of the shares redeemed must be transferred to an undistributable reserve, the “capital redemption reserve fund”, which was to be treated as paid-up capital.

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21 [1922] 2 Ch 444. This exception, related to redeemable preference shares, (that is, a company could redeem its shares if they were fully paid and were expressly stated to be redeemable at the time of issue).

22 This exception, in effect, permits companies to repurchase their shares. Strict controls are however placed on the exercise of this power. Companies may only redeem fully-paid shares and only out of profits which would otherwise be available for dividends, or out of the proceeds of a fresh share issue made for the purpose of the redemption.

23 Great Britain, Board of Trade, Committee on Company Law Amendment, ("Greene Report") Cmd 2657 (1926) paras 28-29.

24 Ibid at 29.

25 Ibid.

26 Companies Act 1929, s 45 (prohibited companies from buying back their own shares) and s 54 (allowed companies to buy-back redeemable preference shares).

27 [1958] 1 Ch 549.
Chapter 2.  

2.2. History of Legislation (English).

The reasoning was that the ‘reserve fund’ does not have the effect of reducing the capital of the company. The capital was only replaced and maintained either by the new share capital or by the capital redemption reserve fund. Presumably, the power was restricted to redeemable preference shares because the possibilities of abuse were reduced, since the shares did not normally afford voting control of the company or fluctuate in value to the same extent as equity shares. There was no definition of ‘preference shares’ for the purpose of s 58. It would, however, appear to cover any shares affording a preference either as regards dividends or capital. Conceivably, then, the section could be used to issue redeemable shares which, because of their rights to further participation, in either or both of income and capital, confer a considerable slice of equity.28

In 1962 the Jenkins Committee considered whether a similar prohibition on share repurchases should be extended to cross and circular holdings, but rejected this somewhat reluctantly because it was thought to involve too many complications.29 The Committee also gave brief consideration to whether a company should be permitted to purchase its own shares. Although the Jenkins Report initially considered that such a power may be useful if stronger protective safeguards were put in place, it did not recommend the relaxation of the Trevor rule, on the grounds that there was no strong pressure for introduction of the reform.30

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28 Previous Acts did not make it clear whether subsidiaries could acquire shares in their holding companies. Cf Companies Act 1948, Table A, Par I, Art 11 and ss 27(1) & (2) which gave the company a lien on partly paid shares issued by it for the unpaid part of the issue price and debts due from the registered holder of the company, and those which prohibited a subsidiary from being a member of its parent or holding company and from acquiring shares in it otherwise than as trustee for persons other than the holding company. Contra Cree v Somervail (1879) 4 App Cas 648 and the Trevor case, which are to effect that a company could not purchase its shares either directly, or through a nominee or trustee. But, that it could accept a gratuitous surrender of it’s fully paid shares.

29 Great Britain Board of Trade, Report of the Company Law Committee ("Jenkins Report"), Cmnd 1749 (1962) 153

30 ibid 168-179. The Report stated: The Commissioners had formed the view that it would be possible to devise efficient and satisfactory safeguards against abuse of the buy-back power...However, we have received no evidence that British companies need this power and that the relatively few witnesses who offered any evidence on this matter were almost unanimous in opposing the introduction of a general power for companies to buy their own shares....There is no justification for the general abrogation of the familiar rule... The Commission entertained the suggestion that a special exception be made to the rule in favour of employee share schemes. The Jenkins Report, though relying on the Trevor rule, did not explicitly explain the rationale underlying its recommendation. It appears that the Committee shared the concern of the courts in the earlier cases mentioned and sought to protect creditors from default risk. However, the Committee’s recommendation seems odd in light of the fact that it approved the American practice of allowing companies to repurchase their own shares. In approving the American practice, the Committee noted that “such a practice had not lead to abuse and it was useful for a number of purposes” (at para 167). One of these purposes was that a company could provide employees with shares as part of a bonus plan and would increase its own shares by repurchasing such shares.
In 1976, the Second European Community Company Law Directive set the parameters within Member States by allowing public companies to maintain the existing exceptions to the Trevor rule but did not require any extension to them. In Articles 19 to 22, the 2nd Directive lays down requirements for Member States to allow public companies to purchase their own shares. Member States can only authorize their public companies to purchase their own shares out of distributable profits. Only fully paid shares may be purchased. The Directive also permits shares to be held in ‘treasury’ subject to certain provisions such as the total amount of shares acquired and held in treasury may not be more than 10% of the subscribed capital. The 2nd Directive was followed by the U.K Department of Trade, Consultative document in 1980 which recommended that the exceptions be widened. Professor Gower, who prepared the Consultation document, came to the conclusion that the advantages of allowing companies to buy-back their own shares were much stronger than any disadvantages. The Green Paper recommended that both public and private companies be permitted to buy-back their own shares and to issue redeemable equity shares. Certain possible reform options were considered by the Green Paper:

- Permit private companies to buy back shares issued under an employee share scheme;

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32 Ibid art 19 (1) (b).
33 Great Britain, Department of Trade, The Purchase by a Company of its Own Shares ("the Green Paper"), Cmnd 7944 (1980). (This document was prepared by L.C.B. Gower, who illustrates a number of advantages in allowing a company to purchase its own shares to appropriate safeguards).
34 Gower, (Ibid). In Para 11, at 9, he outlined a number of advantages in allowing companies to buy-back their own shares. Contra, the document by F. Iacobucci, J. Prichard, M. Pilkington, Canadian Business Corporations: An Analysis of Recent Legislative Developments (1977) 121. Where a similar issue was raised, it was stated:

Considering the potential for abuse of the power and the necessary safeguards and checks which must be adopted, we seriously wonder whether the power to purchase is warranted...[W]e do not believe the case for companies needing the power has been shown to outweigh the serious disadvantages.

Also, see, the Australian position where a similar question was raised (Companies and Securities Law Review Committee, ("C&SLRC") Discussion Paper No 5, A Company’s Purchase of Its Own Shares (June 1986) 2., 32-64.

35 "Green Paper" (Ibid) 20-23. It should be noted that the situation in which public companies were at that time, was mainly motivated by the wish to make private companies more attractive for outside investors. This is illustrative of the reform agenda by the "Green Paper". It should also be noted that the English Company Act that followed the 2nd Directive and Green Paper, did not adhere to the 10% limit provided by the 2nd Directive. Therefore, as will be seen under the current law Companies Act 1985, a UK company may acquire as many shares as it likes so long as it complies with the necessary statutory preconditions. But Cf German law which adopted the 10% limit.
Chapter 2.

2.2. History of Legislation (English).

- Permit private companies the right of self purchase out of capital accompanied by a director's solvency declaration and auditor report
- Expressly permit public companies to issue redeemable equity shares
- Permit public companies to purchase and cancel their shares, and to abide by any security investment exchange regulations
- Expressly permit private companies to issue redeemable equity shares.
- Creditors were to be given the opportunity to challenge any purchase by applying to the court

Generally, the 2nd Directive, and most of the Green Paper were adopted, and inserted as sections 35ff of the Companies Act 1980. However, in the following year, the Companies Act 1981 effectively adopted all the recommendations of the Green Paper. Sections 45-62 inclusive, empowered both public and private companies to repurchase their own shares and to issue and redeem redeemable shares of any class, at any time, if they were authorized to do so by their articles.

The Companies Act 1981, s 45(1) enabled both public and private companies to issue any class of shares on terms that they shall be redeemed at a fixed date or over a fixed period of time. Redeemable shares may not be redeemed unless fully paid. Section 46(2) made provision for the various sources of funds out of which the purchase money had to come. These included distributable profits and the proceeds of a fresh issue of shares. But s 46(3) provided a limited prohibition to prevent a company from carrying out an informal liquidation of its assets by repurchasing its own shares.

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36 Companies Act 1980, s 35(1). Cf s 35(2), 88(1) which did make provision for exemptions where acquisitions were permissible and valid. This was re-enacted by Sched 3, s 43 of the Companies Act 1981. However, s 35(4) of the 1980 Act did stipulate that subs 35(1) shall not apply in relation to the redemption or purchase of any shares in accordance with Part III of the 1981 Companies Act. Section 35 further recast the rule in Trevor, by allowing for the first time a company to hold fully paid shares in itself where it has acquired them otherwise than for a valuation consideration.

37 Companies Act 1981, received Royal Assent on 30th October 1981, ss 45-62. These provisions were brought in as amendments to the Bill being moved in Committee in the House of Lords. In introducing them Lord Mackay of Clashfern stated that the Government was delighted and impressed by the scale and warmth of the response of the Green Paper: "There is a widely felt demand among companies for this facility and keen interest in the government's proposals particularly, but not exclusively, among small companies." (Refer to Hansard (19 March 1981) col 934. See other views expressed by the House in Hansard (1st June 1981) cols 662, 664, 665, 669, 695-700).

38 Companies Act 1981, ss 45(5) and 46 (1).
39 Ibid, s 45(3).
40 Ibid s 60(1).
Chapter 2.  

2.2. History of Legislation (English).

The section is to effect that any amount of any illegal payment is to be deducted from the funds otherwise available to support a distribution. Arguably, if the object of buy-back legislation is to protect creditors and shareholders, then this provision is ineffective.

Even if it may protect creditors, it may have an indirect effect of sacrificing the interests of other shareholders in a dividend to the interest of the vendor shareholders. The power of a company to purchase its own shares is exercisable in three ways which are: a market purchase, an off-market purchase and a contingent purchase; each of which is subject to its special rules. With an ‘off-market’ purchase, both private and public companies negotiate with the selling shareholders under the authority of a special resolution passed by a general meeting of the company. There, the identity of the vendor is known in advance. No member of the company holding shares to which a resolution to buy-back relates is to vote any shares by him on the resolution, whether or not the shares so held will be affected.

With a ‘market-purchase’, only publicly listed companies which, in accordance with investment exchange rules, may purchase their own shares as authorized also, by an ordinary resolution of a general meeting of the company. A contingent contract repurchase is one where, subject to certain pre-conditions, a company becomes entitled or obliged to purchase shares in itself, but there is no immediate binding obligation on the company to purchase and on the seller to sell. An example, is a ‘put option’ given by a company to one of its own shareholders under which the company will become obliged to acquire a certain number of shares from him/her at an agreed price if the shareholder exercises the option.

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41 For a detailed analysis of the protection of creditors and shareholders under the sources of fund and solvency requirements, see section 2.5 below.
42 Companies Act 1985, ss 47-49.
43 Ibid s 47(a) this section, it is to be noted creates an exception to the principle in North West Transportation v Beatty (1887) 12 App Cas 589. (This type of buy-back is now inserted as s 164 of the 1985 Act). It is important to note that the special resolution would be invalid if it would not have been passed but for the votes of a vendor shareholder. The purchase must be made within 18 months of the passage of the resolution.
45 See, 1985 Act, s 159.
Chapter 2. 2.2. History of Legislation (English).

By permitting companies to issue shares which are to be redeemed or repurchased, the Act enabled them to commit themselves contractually to the future application of their assets in reducing their share capital. However, the new powers to issue redeemable shares and to purchase shares were restricted by conditions designed to protect the interests of other shareholders and creditors. In terms of both redeemable shares and purchase of own shares, shares in both cases were cancelled and the company’s issued and paid up capital was reduced accordingly by the nominal amount.

Directors who contravened the repurchase provisions by, for example, authorizing buy-back from funds drawn from capital, were liable to reimburse the company any funds they used to purchase the shares. But there were no specific provisions imposing liability on the directors in respect of purchases of shares out of profits. Consequently, the principles enunciated by the courts would have to be invoked if the company losses were to be recovered from directors. The provisions of the 1981 Act became sections 143-181 of the Companies Act 1985.

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46 There is a certain degree of conflict between the 1980 and the 1981 Acts. The reason behind the apparent conflict in legislative policy is that, the 1980 Act gave full effect to the provisions of the Second Directive imposing prohibitions on acquisition by a company of interests in its own shares, whereas, the Companies Act 1981 took advantage of the exceptions to those prohibitions which strictly fall within the prohibitions. In particular, the 1981 Act does not restrict the acquisition by a company of its own shares to not more than 10% of its issued capital as required by art 19(1) of the 2nd E.C. Directive, only fully paid shares may be redeemed or purchased and in accordance with art 19(1) (b), the number of shares which a company may acquire and hold, was not to exceed 10% of the subscribed capital. There is an elaborate insight into the 1980 & 1981 Acts specifically by, R.R. Pennington, The Companies Acts 1980 and 1981: a Practitioners’ Manual, (1983). See also, N. Bourne, “Purchase by a Company of its Own Shares” (1981) 131 NLJ 387.

47 The power for companies to purchase their own shares is exercisable in three different forms. These include; an off-market purchase (s 47); a market purchase (s 49) and a contingent purchase (s 48). Each of these is subject to it special rules.


49 Sections, 55, 58(2) & 60, also make vendor shareholders liable.

50 Chapter VII of Part V of the 1985 Act (Current legislation), makes provision for companies to redeem shares issued as redeemable shares and to purchase shares whether or not they were issued as redeemable shares. Some of the current provisions are specific either to redemption of redeemable shares or, to the purchase of own shares. Others are common to both. For a detailed overview of the 1985 Act, see, M.C. Wyatt, Company Acquisition of Shares (1995).
2.2.1.1. An Overview of the Present English Legislation

While sections 143-151 recast the Trevor rule prohibiting buy-backs, ss 159-181 have departed from the strictness of that rule by allowing companies to buy-back their own shares. Under the current law, both public and private companies can issue equity shares redeemable at the option of the company or the shareholders. So far as public companies are concerned, the repurchase of its own shares is permitted out of distributable profits or the proceeds of a fresh share issue.⁵¹ A purchase of its own shares can only take place where authorized by the company’s articles and by an ordinary resolution of the shareholders in a general meeting (for purposes of a market purchase), or by a special resolution (in case of an off-market buy-back).⁵² The condition that shares may only be purchased out of distributable profits or the proceeds of a fresh share issue is relaxed for private companies.

Accordingly, in the case of private companies, where distributable profits are insufficient, the shortfall may be made up out of capital.⁵³ However, a special resolution is required and the directors are expected to make a solvency declaration, supported by an auditor’s report, stating that in their opinion the company is expected to remain solvent for a year after the transaction and that it will be able to pay its debts and liabilities within that period.⁵⁴ Holders of shares to be redeemed must not vote on a proposal. The proposal must be advertised in a national newspaper and the official Gazette and any member or creditor may object to the proposal within five weeks of the resolution having been passed in which case the court may approve the proposal or reject it.⁵⁵ Open market buy-backs are also subject to the stock exchange listing rules, which provide minimum requirements on the information to be included in the circular required in seeking shareholder’s authority.⁵⁶

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⁵¹ Companies Act 1985, s 172 defines circumstances in which profits can be regarded as available profits.
⁵² Ibid, s 171.
⁵³ The amount of any payment of capital in respect of such a purchase is limited to the amount which, taken together with any available profits of the company and the proceeds of any fresh issue of shares is equal to the price of the purchase; this amount is referred to as the ‘permissible capital payments’. (See, Great Britain (DTI), Share Buy-Backs (A Consultative Document) (1998).
⁵⁴ Companies Act 1985, ss 171(1) & 173(3). ⁵⁵ Ibid s 177.
⁵⁶ London Stock Exchange Listing Rules, 15.3, 15.9. The stock exchange uses an Integrated Monitoring and Surveillance (IMAS) and Intelligent Alerting System (IAS) as detection mechanisms for identifying potential cases of insider dealing or other market abuses (refer to, Great Britain (DTI) above n 51 at 7). Sections 163-166 re-
Arguably, there is no affirmative justification for imposing a mandatory restriction on the source of funds for buy-backs in public companies. Reliance on the ordinary legal concept of profits has not been renowned for its protective efficacy in connection with dividends. Failing to make buy-back out of profits is regarded as unlawful. It is unclear how a failure to comply with this requirement affects the legality of the repurchase. In the opinion of the writer, two views are possible. One is that just because the acquisition is not lawful does not necessarily mean that it is void. The validity and enforceability of the acquisition in these circumstances depends on the common law rules on statutory illegality. Thus, the transactions are not void but may be unenforceable by the shareholder seller only if he or she is aware of the contravention of the ‘distribution of profit rule’. The other possibility is that, if the transaction is regarded as being unlawful, it contravenes the law and is consequently void. As argued in the Dividend chapter of this study, there is much scope for uncertainty in the dividend rule in Anglo-Australian law. The better approach is for the English to adopt the Australian, New Zealand and Canadian approaches where buy-backs are not made subject to distributable profits but, subject to a solvency requirement.

As concerns the maintenance of capital, s 143 imposes a general prohibition on a company acquiring its own shares (‘a limited company may not acquire its own shares by purchase, subscription or otherwise’). Such acquisition obviously reduces the share capital of the company and thus reduces the fund available to creditors. This is regarded as the statutory confirmation of the traditional English rule. The ensuing provisions of s 143 list the exceptions to the general rule and describes the consequences of any

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57 See, for example, Chapter Five of the thesis below, where the difficulties and problems of defining what is profit and how to determine when profits are available for distribution are advanced.

58 Companies Act 1985 ("CA"), s 143(1).

59 See, Trevor case, above n 5; Re Borough Commercial Building Society (1893) 2 Ch 242.

60 The 1985 Act, above n 36, s 143(3). There are: alteration of objects; litigation objection to re-registration of public company as private and, unfair prejudice provisions under CA 1985, ss 459-461. For an elaborate evaluation of the
contravention. Thus, if a company purports to act in defiance of this prohibition, the company is liable to a fine, and every officer of it who is in default is liable to a fine or imprisonment or both.\(^\text{61}\)

Perhaps most important of all is the final part of s 143(2), which provides that the purported acquisition is void. Although the 1985 Act gives no further guidance as to the consequences of this voidness, these consequences may be deduced by logic. In the case of a purported acquisition by subscription, the shares must remain unissued. In the case of a purported acquisition by purchase, the shares must continue to belong to the party who owned them immediately before the purported transfer.

Notwithstanding the prohibitions under s 143, there is apparently no general rule against a company issuing shares to a person who will hold them as nominee for the company, nor against a person acquiring shares in a company as nominee for that company. In such a situation, the nominee would become the registered holder, and the principle that the register is conclusive as to ownership would preclude any further inquiry into the beneficial title to the shares. To this end, s 144 provides that the shares are to be treated as held by the nominee on his own account and that the company is to be treated as having no beneficial interest in them. Consequently, liability to pay calls for any sum outstanding on the shares must rest elsewhere.\(^\text{62}\) Where the shares are issued to the nominee as a subscriber to the memorandum and in pursuance of an undertaking of his in the memorandum, then joint and several liability to pay is imposed on each of the other subscribers to the memorandum.\(^\text{63}\) Where the shares are issued to or acquired by the nominee in any other circumstance, then joint and several liabilities is imposed on each of the directors of the company at the time of the acquisition.\(^\text{64}\)

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\(^{61}\) Ibid s 143(2).

\(^{62}\) Companies Act 1985, s 144 (2) provides that liability rests initially with the nominee, but adds further provisions in case the nominee fails to pay within 21 days of being called upon to do so.

\(^{63}\) Ibid s 144 (2) (a).

\(^{64}\) Ibid s 144 (2) (b). However, this liability is subject to the provisions of s 144(3), (4). The former of these subsections applies in proceedings for the recovery of sums due under s 144. It empowers the courts to relieve a subscriber or director against liability under s 144 if it appears that he has acted honestly and reasonably and, having regard to all the circumstances of the case, ought fairly to be excused from liability. Section 145 contains provisions restricting the application of s 144. While s 145(1) disapplies s 144(1) (but not the other parts of s 144)
Sections 146-150 make special provision in relation to shares held by or for a public company. Section 146(1) lists the various circumstances for the application of the section:

(a) Where shares in the company are forfeited, or surrendered to the company in lieu, in pursuance of the articles, for failure to pay any sum payable in respect of the shares;

(b) Where the nominee of the company acquires shares in the company from a third person by any of the methods mentioned in s 143(2) (which lists the ways in which a company may lawfully acquire its own shares);

(c) Where the nominee of the company acquires shares in the company from a third person without financial assistance being given directly or indirectly by the company and the company has a beneficial interest in the shares;

(d) Where a person acquires shares in the company with financial assistance given to him directly or indirectly by the company for the purpose of or in connection with the acquisition, and the company has a beneficial interest in the shares.

Where the section applies, there is a limit on the length of time for which the company may retain the shares or any interest in them.\(^65\) If the company fails to dispose of its interests in the shares by the end of the relevant time, it must cancel them and diminish its share capital by the nominal value of the shares cancelled. If this has the effect of reducing its allotted share capital below the authorized minimum,\(^66\) then it must apply for re-registration as a private company, stating the effect of the cancellation. Section 147 allows the directors to take the necessary steps to comply with these requirements without going through the s 135ff capital reduction procedures. Thus, they may pass a resolution altering the memorandum so that it no longer states that the company is a public company and make any alterations requisite in the circumstances.\(^67\)

In accordance with ss 159-181, a company (the acquiring company) is not precluded by s 143 or under the rule in Trevor, from acquiring the shares of another company (the acquired company) in circumstances where the sole asset of the acquired company is

\(^{65}\) Ibid s 146 (2). The period is three years from the date of acquisition in cases falling with (a), (b) or (c) above, and one year from the date of acquisition in cases falling within (d).

\(^{66}\) Ibid, s 117 (£50,000).

\(^{67}\) It appears that this is a case where the memorandum may be altered by a resolution of the directors, rather than a resolution of the company in general meeting.
shares in the acquiring company. This rule is an application of the principle of corporate personality, since the acquiring company will own the shares of the acquired company, but will not own the acquired company’s property. There may be a different problem if the acquired company thereby becomes a subsidiary of the acquiring company, since the subsidiary is forbidden to hold shares in its parent company.

Section 159 allows for the issue of redeemable shares, though at any given time a company must have some shares which are not redeemable within the meaning of this section. The Act however does not provide any guidance on the criteria to be adopted in considering whether to approve or reject a contested proposal for redeeming shares out of capital. It merely allows the issue of redeemable shares but does not prevent validly issued shares from being redeemed at a time when there are no irredeemable shares in issue. In the absence of any reported case on this issue, it is suggested creditors invoke the s 136 reduction of capital procedure which provides an elaborate requirement for creditors to be informed of a proposed reduction and either to consent to it or to be paid-off.

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68 Acatos & Hutcheson plc v Watson [1995] 1 BCLC 218. Cf, British & American Trustee & Finance Corporation v Cooper [1894] AC 399; Re Westminster Property Group plc [1895] 2 All ER 426. Section 143 does not apply also in the purchase of any shares in pursuance of a court order or, the forfeiture or acceptance of a surrender of shares under the companies articles for failure to pay any sum payable in respect of those shares (the right of a company to forfeit shares for non-payment of calls was seen as necessary to prevent co-adventurers from defaulting on their obligation to pay up shares when duly called upon to do so. This is considered a valid and lawful means whereby a company may acquire its own shares. Because a forfeiture of shares deprives a shareholder of its property, a company must strictly comply with the procedure laid down in a company’s constitution: Johnson v Lyttle’s Iron Agency (1887) 5 Ch D 687.

69 Company’s Act 1985, s 23. Generally, the s 143 provision does not also apply to s 159-181 provisions in the following matters: (a) the purchase by a company of any shares of its own fully paid shares where no valuable consideration is given for the acquisition: Re Castiglione’s Will Trusts [1958] Ch 549. This exception was introduced first in the 1980 Act particularly, to assist companies which act as executors or trustees,(b) Section 143 does not further have any effect under the redemption or purchase of any shares in accordance with ss 159-181 or; (c) the acquisition of shares by a limited company on a reduction of capital duly made (the authorised repurchase of share capital sections, have the implication in that, they do not involve any acquisition, rather, the company will often be paying share capital which is in excess of the company’s wants or extinguishing, or reducing the liability in respect of share capital which has not been fully paid up.

70 It is important to understand that redeemable shares in this context are shares which the company is entitled to redeem at its option and irrespective of the wishes of the shareholder. It is also to be noted that an agreement to repurchase shares is not specifically enforceable against the company, nor does breach of it give rise to an action for damages: British and Commonwealth Holdings plc v Barclays Bank plc [1996] 1 All ER 381.
2.2.2. Australian History

The English rule, laid down in Trevor, was recognized and applied by the Victorian Supreme Court in 1894 in Re Federal Bank of Australia Ltd. However, influenced by the Trevor decision and Canadian legislation, the prohibition was finally given a statutory form by the Victorian Companies Act 1896. Section 44 of the 1896 Act, which was the most comprehensive in the Commonwealth at the time, provided that:

“A company is prohibited from directly or indirectly purchasing, dealing in, or lending money or making advances on the security of its own shares.”

This provision was re-enacted as s 273 of the Companies Act 1915 (Vic) without any major changes. Because it was unclear as to whether a repurchase of shares by forfeiture or surrender would contravene the Trevor rule, influenced by the company legislation at this time in the UK, s 273 was replaced by s 33 of the Companies Act 1928 (Vic). It allowed a company, in limited cases, to repurchase its shares by forfeiture and or, surrender. The previous law was later consolidated as s 44-46 of the 1938 Act (Vic). Due to Durack v West Australian Executor Agency & Co Ltd, the previous provisions were repealed by s 56(1) of the 1958 Act (Vic), yet, worded in similar language to the previous Act without much inquiry. In an attempt to unify the existing state legislation the Uniform Companies Act 1961 consolidated the former legislation.

71 (1894) 20 VLR 199.
72 Canadian Bank Act 1890, ss 64 and 100 which prevented a company from dealing in its own shares. Refer to, Victoria Parliamentary Debates (“VPD”) (1895-96) 6152.
73 Companies Act 1896 (Vic), Vict No.1482, ss 44&51.
74 Companies Act 1915 (Vic) (No 2631) was assented to on the 1st of October 1915. Section 273(1) extended the prohibition of a company repurchasing its own shares. It stated: “Except as provided in this Act, no company shall either directly or indirectly purchase or deal in or lend money or make advances or allow discounts upon the security or pledge of its own debentures or debenture stock...”
75 Section 33 assumed that a repurchase by way of surrender or forfeiture does not contravene the Trevor rule. Their Lordships have pointed out that surrender does not involve any payment out of the funds of the company but contended themselves that if it was made in consideration of any such payments: it would be a sale which was invalid. In Bellerby v Rowland & Marwood’s Steamship Co Ltd (1902) 2 Ch 14, it was held that in a surrender of shares, the company releasing the shareholder from further liability in respect of the shares, was equivalent to a purchase and fell within the rule in Trevor v Whitworth.
76 Companies Act 1938 (Vic) (No 4602) Assented to 31st March 1939. Section 44 reapplied the ban on share buybacks, s 45 prohibited a company from giving financial assistance and, s 46, authorized the issuing of redeemable preference shares. Comparatively, see, Companies Acts 1936-1957 (NSW) which inserted similar provisions, prohibiting companies from directly or indirectly repurchasing their shares or from financing members to purchase their own shares. See also, Companies Act 1934 (SA), s 62(1).
77 (1946) 72 CLR 189; See also, Re Castiglione’s Will Trusts [1958] 1Ch 549.
78 Companies Act 1938 (Vic) (No 6455) received Royal Assent on 2nd of December 1958 and came into operation on the 1st of April 1959.
79 One commentator took the view that the general purpose of the 1958 Act was to give better effect to the basic principles underlying company law relative ease of incorporation, maintenance of capital; adequate protection of
Chapter 2.  
2.2. History of Legislation (Australia)

The 1961 Act, which was largely uniform across various states, was largely modeled on the 1958 Act (Vic). It reflected the existing common law restrictions followed by certain exceptions.\textsuperscript{80} In general, a company could not be a member of its holding company, and any allotment or transfer of shares in a company to its subsidiary was void.\textsuperscript{81} The wider policy behind section 17 preventing a company being interested in its own shares or those of its holding company was to prevent the result accepted in \textit{Re Castiglione's Will Trust}.\textsuperscript{82} Under the comparative English legislation which prohibited a company purchasing, dealing in or taking security over its own shares, it was held a company’s shares could be held in trust for the company where no consideration passed from the company. A similar result can follow from a bequest to a company of its own shares when the shares are registered in the name of a nominee. In 1970, the Eggleston Committee pointed out that while a company cannot hold formal title to its own shares, it may be possible for a trustee to hold them on the company’s behalf, at least where the company provided no consideration.\textsuperscript{83} The Committee supported a proposal that would maintain such trust arrangements provided the shares carried no voting rights while they were held.

Despite the fact that companies were prohibited from dealing in their shares or those of their holding companies,\textsuperscript{84} Australian legislation at that time focused more on the narrow exceptions. As a result of the Eggleston Report, Australian companies used a legal ‘back door’ approach, the “Poseidon mechanism,” to establish protective cross holdings between companies. This was useful in supporting existing management and as a defense

\textsuperscript{80} See for example, the \textit{Companies Act 1948} (UK). The \textit{Uniform Companies Act 1961/62} (UCA), was inserted as s 67(1). Section 17(1), added a further strict prohibition. For a detailed analysis of this legislation, see, H.A.J. Ford, “Uniform Companies Legislation” (1964) \textit{4 UQLJ} 138, 138.\textsuperscript{81}

\textsuperscript{81} Ibid. s 17(1). \textsuperscript{82} [1958] Ch 549. See, also, \textit{Kirby v Wilkins} [1929] 2 Ch 444. \textsuperscript{83} Australian Company Law Advisory Committee (Eggleston Committee), Fifth Interim Report, Canberra, Government Printer, (1970). \textsuperscript{84} A similar prohibition is inserted as s 23 of the current 1985 English Act which generally prohibits subsidiaries from being shareholders in their holding company. This mechanism is considered an anti-avoidance measure to prevent companies holding their own shares through a subsidiary. It also serves as a capital maintenance safeguard.
tactic in takeovers. The result of the Poseidon case appears to be that a company can
legitimately gain control over its own shares indirectly even though it is prohibited from
doing so directly. By so doing, the case allows for the establishment of ‘mutual support’
networks and protective cross-shareholdings webs between companies, enabling shares to
be held in support of existing management. The growth in avoidance techniques had the
effect of diluting the force of the prohibition on buy-back.

In April 1977, the Interstate Corporate Affairs Commission (ICAC) released a
discussion paper dealing mainly with proposed amendments to s 67 of the 1961 Act. The
paper contained a proposal that companies be given the go ahead to buy-back their shares
in accordance with protective safeguards. However, the ICAC proposals on company
dealings failed to be adopted perhaps, due to the views of one influential commentator
who stated:

Unless there is a strong countervailing demand for the power to buy-back with strong supporting
advantages in having it, it would seem better not to ‘buy’ into all...[the] problems. But... there
does not seem to be such a strong demand and many of the purposes which a power of purchase
can serve can be achieved... by other means.

In 1981, the Campbell Committee of Inquiry, influenced by changes in the English
Companies Act 1981, and by other changes in Europe and the U.S. which introduced

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85 August Investments v Poseidon & Samin Ltd ("Poseidon case") (1971) 2 SASR 71. There, Poseidon Ltd, sought
to make a takeover bid for Salim Ltd. The latter company held 200,000 Poseidon shares. The court held that the
prohibition on self purchase as provided by s 67 did not extend to a company acquiring an interest in one of its
corporate shareholders. In rejecting any challenge to the transaction, the court relied heavily on the doctrine that a
corporation is a separate legal entity from its managers and members (see Lee v Lee's Air Farming Ltd [1961] AC 12. The
court therefore concluded that a holding company did not obtain an indirect beneficial interest in the shares held by its subsidiary. Using the ‘Poseidon mechanism’, a company may, at least in certain circumstances,
effectively acquire control over a portion of its own shares by acquiring an interest in one or more of its non
subsidiary corporate shareholders. The soundness of the court’s decision is not quite clear. Even if the decision is the
correct one, arguably, the court was only concerned with assessment of whether the holding company thereby
obtained a legal or equitable interest in itself and the majority paid no regard to the undoubted practical influence
that a holding company would be able to impose on its subsidiary’s management of the subsidiary’s assets,
including the shares in itself.


87 Ibid, Para 5.3. According to "ICAC", it was suggested that the position of the Canadian Lawrence Committee in
relation to share buy-backs was more compelling than that of the UK’s Jenkins Committee. The safeguards
suggested by ICAC, included: (a) Shares held by or for the company itself would carry no voting rights, (b) it
would be left to the company to decide whether the shares were to be held for resale or cancelled, (c) full
disclosure requirements should follow any buy-back. There has been a wide ranging debate by commentators on
the desirability of companies being allowed to buy-back their own shares (see for example, J. R. Coombes; R. B.

88 D. Harding, "The ICAC Proposals Regarding Purchase of a Company’s Shares" (1978) 10 Comm Law Ass Bull 53
Also, the National Companies and Securities Commission Release 400 was also against relaxation of the buy-
back prohibition which, according to them, received little support and a great deal of well argued opposition.
provisions allowing companies to repurchase their own shares, suggested that the question as to whether companies be permitted to purchase their own shares be re-opened in Australia.\textsuperscript{89} The Campbell Report recommended that the National Companies and Securities Commission (NCSC) be given powers, subject to appropriate safeguards, to allow companies to buy-back their own shares.\textsuperscript{90} The recommendation was not instantly acted upon. However, s 67 of the former legislation was consolidated and inserted as s 129 of the \textit{Companies Act 1981},\textsuperscript{91} with minor changes.

The new section extended the existing common law rule with some exceptions, which contained provisions allowing companies to issue and subsequently redeem, redeemable preference shares under certain conditions.\textsuperscript{92} The proviso had the effect that, the redemption must comply with the company’s articles. The funds must either come out of profits otherwise available for dividends or from a fresh issue of shares expressly for the purpose. The shares must also be fully paid.\textsuperscript{93} If the shares are redeemed out of profits, a sum equal to the nominal amount of the shares redeemed must be transferred from profits to an account called the ‘capital redemption reserve’. The exemption of buying-back shares by redemption of preference shares was believed to protect creditor’s interest in the sense that the buy-back can only be redeemed out of distributable profits or the fresh issue of shares. As a sum equal to the nominal value of the redeemed shares was transferred to a capital redemption reserve, it was assumed the company’s capital was not reduced but the issued preference share capital was simply replaced by the capital redemption reserve.

\textsuperscript{89} Australian Financial System, Final Report of the Committee of Inquiry ("The Campbell Report"), (1981) paras 21.93-21.99 at 78-80. In particular, the Committee having reviewed the position in other jurisdictions, stated in its report that a power would permit and facilitate corporate restructuring to meet changing circumstances, make it easier for unlisted companies to attract outside shareholders and facilitate the development of stock options schemes by enabling a company to purchase an employee’s shares upon retirement (at Para 21.97).

\textsuperscript{90} Ibid 21.99.


\textsuperscript{92} \textit{Companies Code 1981}, s 120(3) (a-c). Section 36(1) reenacts former s 17(1) prohibiting a subsidiary company becoming a member of its holding company. But, as already indicated above, the growth in avoidance technique by the use of the "Poseidon mechanism" renders this prohibition useless. Further exceptions not contravening s 129 concerns the reduction of capital provisions under s 123 of the 1981 Act, and s 320, on oppression orders.

\textsuperscript{93} Ibid, ss 120(3) (a-c).
Chapter 2.  2.2 History of Legislation (Australia).

Obviously, there is some reason to believe that a buy-back by redemption of shares does not breach the Trevor rule. This is so in the sense that redeemable preference shares may have more in common with debt than equity and it will be irrational to prohibit companies to buy-back their debts.\(^94\) Moreover, unlike buy-backs which are applicable mostly to ordinary and equity shares, redeemable preference shares are issued on the understanding that they will be redeemed at some point in future, but ordinary shares to be bought back are not. Although there is not the same danger of abuse or prejudice to shareholders and creditors as in the case of a buy-back, however, preference shares are usually viewed as more analogous to debt. Where shares are redeemed, all the shares of that class would be subject to redemption so that the shareholders are treated equally.

Section 129 prohibited three categories of transactions. These were:

- A company acquiring its own shares or units of shares;\(^95\)
- A purported acquisition by a subsidiary of shares or units of shares in its holding company\(^96\)
- A company lending money on the security of its shares or units of shares in itself or in its holding company.

Sections 129(5), read together with ss 563 and 564, made provisions for breaches of the self purchase powers by imposing criminal liability on ‘officers’ in default should a company unlawfully acquire its own shares.\(^97\) Closely linked to the liability of directors was the question of the liability of vendor-shareholders. They are required to return to the company some if not all of the money realized by the sale of the shares to the

\(^{94}\) See, Kessler above n 3, 645.
\(^{95}\) Companies Code 1981, s 129(1) (b) (i).
\(^{96}\) Ibid. s 129 (b) (ii).
\(^{97}\) The above subsections penalized defaulting officers with a conviction of two years imprisonment and/or with a $10,000 fine. Defaulting officers could also be ordered to pay compensation to the company or any other person of such amount as the court pleased (s 129(6)). The s 129(5) liability is not applicable to the company. This was as a result of the Eggleston Committee Report where it was suggested that if the real object of the self-repurchase prohibition was to protect creditors and remaining shareholders, little would be achieved by imposing a criminal liability on the company (Eggleston Committee, above n 83 para 94). Directors are also in breach of their fiduciary duties under s 229 if they acted without due diligence and care in the preparation of statements to shareholders. It is noteworthy that prior to the 1981 Act, a transaction breaching the prohibition against companies purchasing their own shares was only illegal and void, the company could not recover any money it had expended (see, Dressy Frocks Ltd v Bock (1951) 51 SR (NSW) 390). This was unsatisfactory, and lead to the enactment of s 130 of the 1981 Act. The Companies Act 1981, s 130(4) provided that if's 129 was contravened, a court could make such orders as it thought just and equitable against any party: to the contract, or against the company or against any person who aided, abetted or was knowingly concerned in the contravention including orders directing a person to refund money or return property to the company or to indemnify another.
company in certain circumstances. Influenced by the English relaxation and lifting of the prohibitions on buy-backs and also probably because of increasing familiarity with the American corporate world among Australian companies and their advisers, the debate as to the desirability of allowing companies to purchase their own shares was raised in 1986 by the Companies and Securities Law Review Committee. In its final Report, submitted to the Ministerial Council in 1987, it recommended that s 129(1) (b) (i) be amended to permit a company to buy-back its own shares, and that a company’s power to acquire its own shares include acquisitions either by an on-market purchase, a pari-passu offer to all shareholders or, a selective buy-back from an individual member.

The recommendations were implemented by ss 204-206 of the 1989 Companies Act. Companies could buy-back both ordinary and preference shares. The 1989 amendments contained a number of restrictions which were designed to guard against misuse of the power, while affording adequate protection to creditors. Section 205(1) (b) (i) incorporated the House of Lords sentiment by prohibiting a company from directly or indirectly acquiring shares or units of shares in itself or its holding company. This provision was included to statutorily overcome the finding in Bond Corporation Pty Ltd v

98 Cf the American position, where s 48 of the “MBCA” is to effect that when directors are made liable, they are entitled to contribution from the shareholders who received the corporation’s assets knowing this was in contravention of the Act. The section, allows the directors to recover from the shareholders if they knew the transaction was illegal. It is unclear if this type of provision is of any benefit to creditors. The provision in the English legislation applies only in circumstances where payment for the shares came out of capital. It is specifically provided in s 60(2) of the 1981 Act that the provision in s 44 of the 1980 Act dealing with the consequences of unlawful distribution are not to apply to any payment by the company in respect of the redemption or purchase of shares in the company by the company.


101 Sections 204-206 were designed to ensure that the interests of company members and creditors were not unfairly prejudiced.

102 Co-operative Scheme Legislation Amendment Act 1989 (Cth). Received Royal Assent on 27th June 1989. (To be later known as the Corporations Law “CL”). Among the legislative prescriptions to permit buy-backs, were requirements including changes to the company’s constitution before initiating any buy-back scheme, detailed disclosure requirements, strict limits on the proportion of shares that could be purchased, and stringent shareholder approval requirements.
Chapter 2. 2.2. History of Legislation (Australia).

White Industries Ltd\textsuperscript{103} to the effect that s 205’s predecessor did not prevent a company holding a beneficial interest in its holding company’s shares. The prohibition extended to the purchase of the shares of the holding company as this would indirectly reduce the holding company’s assets.

The concern for the ability to invoke the exceptions to s 205 (1) empowered the Australian Securities Commission (ASC) to declare, as unacceptable, schemes that enabled a company to acquire a relevant interest in more than 10% of its voting shares.\textsuperscript{104} The ASC could make such a declaration if there was a likelihood of the scheme being prejudicial to the company, its creditors and other members. Under this legislation, a company could, under s 206BE, acquire 10% of its current shares on issue, within a 12 months period.\textsuperscript{105}

The Act also permitted five types of buy-backs with each type subjected to different regulation.\textsuperscript{106} In the case of public companies, the company’s auditors were required to make inquiries into the company’s state of affairs and to certify that it was not unreasonable for the directors to sign a declaration that the company was solvent.\textsuperscript{107} This solvency declaration (used in its liquidity sense to refer to the ability of the company to pay its debts as they become due and payable), had to be in force when a buy-back

\textsuperscript{103} [1980] 2 NSWLR 315

\textsuperscript{104} See Divs 4A & 4B of Pt 2, ss 206AAB (3), 206AAD (1) (b).

\textsuperscript{105} This became generally known as the ‘10/12’ limitation. See, Companies Act 1989, ss 206BE; 206EA. For commentaries on this legislation, see, J. Hewett, “Share Buy-backs for Australian Companies” (1990) 8 C & SLJ 1

\textsuperscript{106} The various types of buy-back under ss 206FD & 206FE included: (a) Equal access scheme -applicable to ordinary shares -where the company makes uniform offers to each shareholder to buy back a uniform percentage of each shareholder’s ordinary shares; (b) On market buy-back -a company listed on the Australian Stock Exchange buys its shares in the normal course of trading in compliance with listing rules; (c) Minimum holding buy-back-a company listed on a securities exchange buys back parcels of shares which are not marketable parcels on the exchange; (d) Employee scheme buy-back-a company buys shares held by, or for the benefit of, current or former employees under an existing employee share acquisition plan approved by shareholders, and (e) Selective buy-backs-is one in which a company buys-back from a particular shareholder, otherwise than in any of the above four ways. This also requires the buy-back to be approved by a special resolution which necessitated the approval of 75% in number of members entitled to vote, who together held at least 75% of the company’s share capital (s 206JA). In some of these various modes of buy-backs, creditors were given the opportunity to object to any detrimental buy-back. The company was also required to advertise its intentions, so as to alert creditors and inform them of defined documentation available for inspection. In accordance with s 133, after any permissible buy-back, the shares had to be cancelled. Contra the US approaches, where shares after being bought-back, are retained as treasury shares. Apart from the statutory pre-conditions under the Act, companies wishing to buy-back their shares had to also satisfy the ASX Listing Rules 3V.

\textsuperscript{107} Corporations Law 1989 (Cth), s 206BI.
commenced. Nonetheless, solvency declarations are of questionable worth. It is possible to envisage circumstances where a declaration as to solvency could technically be made notwithstanding the fact that on an alternative definition of insolvency (i.e., the 'balance sheet insolvency'-meaning, the company's liability exceeding its assets), the company is actually hopelessly insolvent.  

Despite these positive changes to the common law rule, commentators argued that companies were however, reluctant to use this new statutory power because of the legislative requirements which were perceived as being excessively onerous. Others took the view that the Australian position, as compared to the United States, was too rigid and highly regulated, imposing high transaction costs on companies which prevented them undertaking such buy backs. In July 1994, the Corporations Law Simplification Task Force released an Exposure Draft of the First Corporate Law Simplification Bill which proposed substantial amendments to the existing buy-back legislation culminating in the First Simplification Act 1995. The legislation was immediately preceded by the Second Simplification Act 1996. According to the Task Force, few Australian companies carry out share buy-back "because the existing provisions were complicated and included unnecessary procedural steps... and duplicated regulation elsewhere in the Corporations

108 Ibid, s 206BB. Directors could be held liable to the company for the payment out to the shareholders in the event that a company was brought under official management or if winding-up is commenced within twelve months after the purchase.

109 For a detailed overview of some defects in the use of the 'solvency requirements,' see, the writer's analysis below, subpart 3.2 (on creditor protection). See also, the view points of B. McCabe, "The Desirability of a Share Buy-back Power" (1991) 3 Bond LR 56, 60; E. Magner, "The Power of a Company to Purchase its Own Shares: A Comparative Approach" (1984) 2 C&SLJ 79, 86-160.


111 See, generally, D. Parlett & G. Burton, "The Share Repurchase Albatross and Corporate Law Theory" (1989) 62 AJL 140 (remarked that the language and substance of the "C&SLRC" recommendations largely cling to the old ideas and the welfare paradigm); L. Factor, "Capital Maintenance: Simplification and Creditor Protection" (1995) 5 AJCL 270, 272 (said, unlike the U.K., U.S. and Canadian buy-backs legislation, the Australian share buy-back provisions were overly complex and difficult to comply with (at 270). See also, J. Hewett, "Share Buy-backs for Australian Companies" (1990) 8 C&SLJ 383, 384. Cf the Delaware Law of Corporations and Business Organisations, s 6 which for example, provides a less regulated environment by expressly empowering companies to purchase their own shares with few restrictions. There, the minimal restrictions are that, directors must comply with their general fiduciary duties to act in the interests of the corporation and that, a buy-back must not result in insolvency of the corporation. The fund used to buy-back shares was limited to surplus funds. (Refer also to H. Henn & J. Alexander, Laws of Corporations, 4th (ed), 1990).

Chapter 2.  

2.2. History of Legislation (Australia).

Law. The First Simplification Act inserted section 205 repealing s 129 of the previous legislation. The legislation broadened the scope of the buy-back power and removed some of the procedural requirements in s 129. The Second Simplification Act designed to deregulate and reduce the procedural requirements for transactions which did not threaten the interests of a company, its shareholders and creditors. By significantly relaxing and simplifying the provisions on buy-back for both public and private companies, both Simplification Acts also removed court involvement from transactions which did not involve a dispute.

Both Acts also removed the need for companies to have buy-back authorizations in their constitutions. Directors of a company wishing to undertake a buy-back were no longer required to sign a solvency statement under which they may be liable for a period of twelve months from the date of the statement should the company become insolvent. Rather, directors would only be personally liable if, at the time of the buy-back, the company was insolvent. A public company could also buy-back more than 10% of its shares in a twelve month period, without the need of an auditors’ report, provided it obtained the approval of more than 50 percent of shareholders who voted on the resolution. As concerns a selective buy-back, the shareholder approval requirement was lessened with only 75 per cent of shareholders voting being required to approve the resolution (with no votes being cast in favour of the resolution by any person whose shares were proposed to be bought-back). The 1995 and 1996 Acts, although they substantially simplified the procedures, also required shareholder approval and a detailed disclosure notice. The later provisions were consolidated and inserted as ss 257A-257J of the Corporations Act 2001 representing the current position on buy-backs.

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114 Another reason given by the task force as to why few Australian companies undertook buy-back was because of the significant personal liability imposed upon directors in the context of a buy-back; thirdly, because of the complexity of accounting issues involved with buy-backs. (See generally, D. Bruce, “Share Buy-backs” (1990) 2(1) Decisions 29, 31; R. Warren, “Share Buy-back: Traps and Pitfalls” [1991] J of Securities Institute of Australia 18).

115 See, Second Simplification Act, s 206.


118 Ibid, s 206C. All documents relevant to the buy-back transaction were to be forwarded to the Australian Securities Commission (ASC). Any transaction in contravention of s 205 or 206 did not render the transaction void and
2.3. The Mechanisms of the Current Australian Statutory Buy-Back Regime

2.3.1. Relationship between Reductions of Capital & Buy-backs.

Section 256A (a-c) inclusive, which mirror both buy-back and reduction of share capital rules, states that they are designed to protect the interests of creditors and shareholders by; addressing the risk of these transactions leading to the company’s insolvency, seeking to ensure fairness between the company’s shareholders and, by requiring the company to disclose all material information.

Accordingly, subject to any prohibition or restriction in its constitution, a company may buy-back its own shares (including redeemable preference shares) if the buy-back does not materially prejudice the company’s ability to pay its creditors, and the company follows the applicable statutory procedure. Section 257A (a) and s 256B (1) (b) are related in the sense that both capital reduction and share buy-back transactions require that transactions do not result in the company materially prejudicing the company’s ability to pay its creditors. They seek to safeguard the protection of creditors by making sure that the transactions do not result in the insolvency of the company.

However, section 257A (Note 1) contrasts with share capital reduction in that a reduction is not made subject to a constitutional limitation unlike in a buy-back proposal where s 257A (Note 1) expressly states that if a company has a constitution, it may include provisions in the constitution that preclude the company buying back its own shares or, it may impose restrictions on the exercise of the company’s power to buy-back its own shares.
Chapter 2.  

2.3. Methods & Procedures

However, the concepts of ‘equal access scheme’\(^{121}\) and ‘selective buy-back’\(^{122}\) mirror their share capital reduction counterparts. Both selective buy-back and selective reduction of capital proposals must be approved by a special resolution of shareholders with the selling shareholder (s 257D(1)-buy-back) and the shareholder receiving consideration (s 256C(2)-reduction) and their associates, precluded from casting their votes in favour.\(^{123}\)

Both equal access scheme buy-back and equal reduction of capital require that shareholders be treated equally and on a pro rata basis.

Though both a buy-back and a reduction of capital can be carried out selectively, a selective buy-back, unlike a reduction of capital, is not a technique for compulsory acquisition, because it depends upon the willingness of the shareholder to sell. However, both are means of removing or eliminating a minority shareholding. Moreover, while an independent expert valuation and report is required for the purposes of a selective buy-back, the consideration paid to minority shareholders whose shares are cancelled under a selective reduction, is not subject to an independent expert valuation. There is a capacity for judicial involvement in a reduction of capital but little or no court involvement in a share buy-back. A reduction of capital generally is not carried out subject to the company’s constitution though, for purposes of the variation of rights provisions, a selective reduction may be considered to vary the rights of shareholders under the company’s constitution.

2.3.2. Methods and Procedures of a Share Buy-back

Section 257B (1) adopts the five different types of buy-backs seen under the previous legislation, with different applicable procedures according to the type of buy-back.

\(^{121}\) Corporations Act 2001, s 257B (2) (See what this scheme is below at s 2.3.2.3.).

\(^{122}\) Ibid.

\(^{123}\) See, Village Roadshow Ltd v Boswell Film GmbH (2004) 49 ACSR 27.
2.3.2.1. Minimum Holding Buy-Back

A minimum holding buy-back is defined by s 9 as a buy-back of all of the holder’s shares in a listed corporation if the shares are less than a marketable parcel within the rules of the relevant financial market. Under the ASX rules, the number of shares in a marketable parcel is dependent upon the market price of the shares; in general, the lower the market price, the greater is the number of shares required.\(^{124}\) The Australian Stock Exchange has retained a definition of ‘marketable parcel’ in both its listing and Business Rules. According to the Explanatory Memorandum to the Corporate Law Review Act, the ASX retained the marketable parcel concept because of its relevance to the Security Clearing House Business Rules and, in particular, the rule prohibiting the creation of new holdings of less than a marketable parcel.\(^{125}\) In accordance with the ASX rules, a marketable parcel of shares including redeemable preference shares with a fixed and certain date for redemption is a parcel of not less than $500 based on:

- The closing price on the Stock Exchange Automated Trading System ("SEATS")
  the shares are quoted, or
- The price paid on issue, if the shares are unquoted.

The law does not require a minimum holding buy-back to be approved by a general meeting. Nor, does it expressly regulate the manner in which minimum holding buy-back offers are made except to require each offer to relate to shares in the relevant unmarketable parcel. However, shares to be bought back and cancelled, must be notified to ASIC, by the acquiring company in relation to the number of shares acquired and automatically cancelled.\(^{126}\)

2.3.2.2. On Market Buy-Back

This is a buy-back which results from an offer made by a listed company on a prescribed financial market in the ordinary course of trading on that market.\(^{127}\) A buy back by a company which is unlisted is also an on market buy-back if it results from the offer made in the ordinary course of trading on a market or body corporate that operates a securities

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\(^{124}\) See generally, ASX Listing Rules 19.12; ASX Business Rules definition.


\(^{126}\) Refer, generally to, sections 254Y; 257B (2) and 257H.

\(^{127}\) Corporations Act 2001, s 257B (6) and ASX LR 3.8A; 7.29-7.34.
market outside Australia; and ASIC declares in writing to be an approved overseas financial market for the purposes of s 257B (7). If the company acquires the shares through the ASX, the other requirement is for the approval of the company’s shareholders by ordinary resolution in a general meeting, if they will cause the company to exceed the ‘10/12’ limit.\(^{128}\) The resolution under this type of buy-back must be passed before the proposed buy-back agreement is entered into unless the agreements are conditional on that approval being obtained.\(^{129}\)

An ‘On market buy- back’ must also conform to ASX rules 7.29 & 7.33, where the buy-back scheme involves quoted securities. An ASX Listed company may only buy-back shares on market if transactions in the company’s shares were recorded on the ASX on at least 5 days in the 3 months before it buy-backs the shares.\(^{130}\) A listed company intending to buy-back must also lodge a notice to that effect with ASIC at least 14 days before the first of the buy-back agreements is entered into.\(^{131}\) Where the company intends to make only a minimum holding buy-back, it must lodge the Form App 3C document of the listing rules, to the ASX.\(^{132}\) Where it is an Open Market buy-back, the relevant document must disclose the name of the broker who will act on the company’s behalf and the maximum number of shares to be bought-back. Under the ASX, the purchase price for an On Market buy-back must not exceed 5% above the average of the market price of shares of the same class over the last five days on which sales of the shares were recorded before the day on which the purchase under the buy-back was made.\(^{133}\)

While the concept of the free market in publicly traded securities has long been embodied in Anglo-Australian law, it is a commonly expressed concern that companies may use the on market power of buy-back for the purposes of manipulating the market price or distorting market information in the form of insider trading.

\(^{128}\) Cross refer to s 2.3.2.6 below, where the 10/12 limit is explained in detail.
\(^{129}\) Ibid s 257C(1)
\(^{130}\) ASX Listing Rule, 7.29.
\(^{131}\) Corporations Act, 2001 ss 257F (1) (a-b), 2(b).
\(^{132}\) ASX Listing Rule 3.8A. Such a document, contains information relating to the type of buy-back, class of shares which is to be bought-back, voting rights of that class of shares, details of the extent to which the shares are fully paid, reasons for the buy-back and other relevant information to enable the shareholder decide whether to accept the offer.
\(^{133}\) ASX LR 7.33.
Although the regulation of listed companies through the ASX augments the provisions of the Corporations Act and attempts to ensure transparency and to prevent manipulation and other irregularities it is still doubtful as to whether an aggrieved party from a buy-back transaction may seek redress under the insider trading provisions. It is the writer’s view that a better approach is to seek the aid of both the insider trading legislation especially concerning misleading information and the aid of the criminal law where such abuses are adequately addressed.

2.3.2.3. Equal Access Scheme

An equal access scheme under s 257B carried out by both listed and unlisted companies must relate only to ordinary shares and the offers extended to ordinary shareholders must be the same (i.e., the company makes uniform offers to each shareholder to buy-back a uniform percentage of each shareholders ordinary share). Under s 257B (2) (a-e) inclusive, certain pre-conditions must be satisfied. These include:

- offers under the scheme to relate only to ordinary shares;
- the offers to be made to every person who holds ordinary shares to buy-back the same percentage of their ordinary shares;
- all of the offerees must have a reasonable opportunity to accept the offer made to them.

The offerees must have at least one month in which to accept the offer.

Arguably, under the present legislation, offerees are merely required to have a reasonable opportunity to accept. What is also unclear under this requirement is the absence of a clearer explanation as to when an opportunity is reasonable so as to enable offerees to accept or reject an offer. The Explanatory Memorandum does not make any due reference to a similarly worded s 602. It has been argued by one commentator that there is the

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134 See, the section 2.5 below, concerning disclosure and policy issues, where the issue of insider trading and buy-back is discussed.
135 See for example, the views expressed by, H. S. Bloomenthal, "Market-Makers, Manipulations and Shell Games" (1971) 45 St John’s LR 597; M. R. Moskowitz, “Corporate Stock Repurchases under the S. E. Act of 1934” (1971) 51 Nebra LR 193; 226.
136 Corporations Act 2001 (Cth), s 257B (2-3).
137 Cf s 624 (1). This was a similar position under the former s 206FB (6) buy-back regime.
possibility of the term ‘reasonable opportunity’ to be widely construed so that it might extend beyond the mere physical possibility of responding to an offer within the time frame set by the offeror.\(^{138}\)

- Buy-back agreements under an equal access scheme must not be entered into until a specified time for acceptances of the offers has elapsed. This requirement assumes that all offerees are treated equally. Par excellence, it prevents a company unilaterally choosing an offer once certain offerees have accepted.

A possible argument against this requirement is that though buy-back agreements cannot be entered into until a reasonable stated offer period has expired there is no express prohibition on an offeror company paying consideration, prior to the end of the offer period, to an offeree who has purported to accept the offer. Under the former legislation, s 206ME prohibited such payments.\(^{139}\)

- The terms of offer are the same for all the offerees.

It is to be noted that under s 257B (3) (c),\(^{140}\) notwithstanding that differences in the offers introduced are solely to ensure that each holder is left with a whole number of shares, it remains an equal access scheme. Further, according to ASIC, there must be a pro rata scaling back of acceptances.\(^{141}\) Since information disclosure is a crucial criteria in all transactions affecting share capital, any company undertaking an equal access scheme buy-back needs to include in the offer a statement setting out all information known to the company that is material to a shareholder’s decision whether to accept the offer.\(^{142}\) Shareholders need only approve the terms of an equal access scheme by ordinary resolution if it would cause the company to exceed the ‘10/12 limit.’\(^{143}\)

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\(^{139}\) This point of view is consistent with that of J. Hambrook, ibid at 26.344.

\(^{140}\) Section 257B (3)(c) relates to matters to ignore concerning an equal access scheme. It states that in applying subsection (2), ignore differences in the offers introduced solely to ensure that each shareholder is left with a whole number of shares.


\(^{142}\) Corporations Act 2001, ss 257B (1), 257G. Special obligations are provided for listed companies by the ASX LR 3.8A which requires that a Form APP 3C to be lodged with ASX stating among other things, the percentage of shares proposed to be bought-back, the total number of shares proposed to be bought-back if all offers are accepted, the price offered.

\(^{143}\) Ibid s 257B (1) and s 257C (1). Where the 10/12 limit would not be exceeded, ss 257F (1) (b); 257E & 257F (2) (a) inclusive, require that 14 days before the buy-back agreements are entered into, the company lodges with ASIC a document setting out the terms of the buy-back offer and any document which accompanies the offer. Section 257F (2) (Note 1) stipulates the conditions if a company intends to enter a buy-back less than 14 days.
Chapter 2.  2.3. Methods & Procedures (Equal Access Scheme)

The resolution must be passed before the buy-back agreement is entered into unless the agreement is conditional on the resolution being passed.\textsuperscript{144}

As the name suggests, the strict conditions for an equal access scheme seek to ensure that there is equality in treatment for all ordinary shareholders especially as concerns unlisted companies since they ensure members are offered a ‘pro rata’ payment of the company’s assets.\textsuperscript{145} A historical presumption relating to shares of a corporation is that the rights of shareholders are equal in all respects.\textsuperscript{146} The legislature, in (s 257B (2)), has intended that goal of ‘equality’ to be obtained. However, the concept of ‘equality’ in such a buy-back may be misleading. Firstly, a public policy issue arises when a company does not repurchase shares equally from all shareholders. Though s 257B (2) could ensure a problem of dilution is prevented, dilution arises where a company pays too much for the shares it bought-back, diluting the value of the remaining equity.

The pro-rata requirement, while affording some degree of protection against financial dilution, does not guarantee equality of treatment, or even the opportunity for equal treatment with respect to dilution of voting strength. Unless every member of the class sells the same proportion of his/her shareholding—a near impossibility in the absence of full disclosure to each person of what all the others are doing, some dilution is bound to take place.\textsuperscript{147} What the pro rata rule does with respect of voting power, however, is to add somewhat to the basic equitable protection given to shareholders against the misuse of management powers under the so called ‘proper purpose’ doctrine.\textsuperscript{148}

Moreover, for purposes of listed companies, the equality conditions do not necessarily present all shareholders equality of opportunity to receive a pro rata payment of the

\textsuperscript{144} Ibid s 257C (1).
\textsuperscript{145} The pro-rata requirement is obviously designed to protect the interest of shareholders. It is to afford each member of a class the same opportunities as every other member of that class.
\textsuperscript{146} Refer to, Birch v Cooper [1889] 14 App Cas 525; R v McClurg [1990] 3 SCR 1020.
\textsuperscript{147} See, I..Getz, “Corporate Share Repurchases” (1975-76) 9 U British Col LR 9, 16.
\textsuperscript{148} The literature on this doctrine is now voluminous, especially since the decisions of: Ampol Petroleum Ltd v Miller (Holdings) Ltd [1972] 2 NSWLR 850; Howard Smith Ltd v Ampol Petroleum Ltd [1974] 1 All ER 1226. See also, the decision of Berger j in Tech Corporation Ltd v Milar (1973) DLR (3rd) 288; J.S.Ziegler, “Directors’ Power and the Proper Purposes” [1974] JBl 85.
company's assets. Small investors, for example, holding just a few lots of shares may find that they will be left with odd numbers of shares after a buy-back. The pro rata requirement provides no protection at all against financial dilution of members holding shares of a class other than the one to be acquired, and it is obvious that the interests of one class can be severely prejudiced by the acquisition of shares of another class—since the Corporations Act does not adequately prevent a buy-back in circumstances that would otherwise amount to a reduction of capital. Moreover, it seems highly unlikely that the shareholders prejudiced in this way would be able to claim the protection of the variation of rights machinery in the Act. This is in view of a long line of English decisions, such as Re Saltdean Estate, which distinguish between a variation of the rights, which is protected, and an interference with the enjoyment of the right (for example, by imposing a capital cushion) which is not protected.

Furthermore, where a company intends acquiring shares proportionally from all ordinary shareholders who offered to sell their shares, it is uncertain whether the offer must be taken up pro-rata to the total shareholding of each shareholder offering to sell his/her shares or, if he/she does not offer all his shares, with reference only to the number of shares offered by him. If the legislation is silent on this, it is suggested that regard must be had to the number of shares actually offered by each ordinary shareholder willing to sell shares to the company. It is possible for example that a shareholder holding 500 shares may offer to sell only 50 of them to the company. If one determines the number that must be acquired from him/her with reference to his or her total shareholdings, the absurd situation may arise that the company has to take up the offer in respect of more shares than the shareholder is willing to sell. It can be argued therefore that the equality conditions under s 257B do not go far enough to address the predicaments that confront small investors. The equality conditions do not sufficiently assure practical equal access. This is a loophole in the current legislation since it assumes falsely that all ordinary

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149 [1968] 1 WLR 1844. Also see, House of Fraser plc v ACGE Investments Ltd [1987] AC 387; Re Village Roadshow Ltd (2003)48 ACSR 167 (A resolution to approve a scheme of arrangement, under which a company will have the obligation to buy-back some of its shares, at least where the terms of issue of the shares did not contemplate the company having such an entitlement) per Mandie J.

150 This argument also finds support in, K. Vander Linde, "A Company's Purchase of its Own Shares" [1999] JBL 68, 70.
shareholders are treated equally while in practice, it favours only large shareholders at the expense of small investors. It is suggested that the ‘equality concept’ in equal access schemes can be fine-tuned to safeguard the interests of small investors on the market. This can be done by perhaps a qualification to the rule that the company can only offer to repurchase a fixed percentage from each shareholder. With a listed company, the ‘rounded-up rule’ should apply, that is, the rule should be subject to an overriding condition that where the fixed percentage set by the company results in an offer to purchase an odd number of shares, the offer shall be deemed to be an offer to purchase the number of shares representing the next nearest rounded up number of lots (such a deeming provision would ensure that small investors will not face the prospects of odd lots after repurchase).\(^{151}\) At the same time, it would safeguard against the moving of value away from small investors to the owners of large investors.\(^{152}\)

### 2.3.2.4. Employee Share Scheme.

With this type of buy-back, a company repurchases shares held by, or for the benefit of, current or former employees, including executive directors, under an existing employee share acquisition scheme that has been approved by the company in general meeting.\(^{153}\) Both sections 257B and D, refer to an employee share buy-back as a scheme under which shares (or units of shares) in the company or a holding company may be acquired; by, or for the benefit of employees of the company, or a related body corporate; or directors of the company, or of a related body corporate, who hold a salaried employment or office in the company, or is a related body corporate. General meeting approval is required for such a scheme of buy-back if the 10/12 limit is exceeded. The company has no obligation to disclose information to the relevant employees or to treat them equally. However, a company which fails to disclose materially price sensitive information to employees prior to acquiring their shares might contravene the insider trading provisions.\(^{154}\)

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\(^{151}\) Although s 257B (3) (c) assumes to cover this problem, its language remains unclear.


\(^{154}\) Cf ss 1002G (2), 1013 (1) (liability for insider trading) and s 995 (misleading conduct).
Companies listed on the ASX and proposing an employee share scheme buy-back must also comply with ASX Listing Rule 3.8A. The company is required to lodge Form App 3C with the ASX when it decides to make the buy-back. The form also indicates the number of shares to be bought-back, and the price to be offered for them.\textsuperscript{155} By allowing companies to buy-back shares from current or former employees, the current law overrides the common law position, where a company could not lawfully buy-back its own shares from its employees, whether on cessation of their employment or otherwise.\textsuperscript{156}

The employee share scheme buy-back encourages and facilitates the holding of shares in a company for the benefit of bona fide employees and former employees. It is, however, unclear how that objective can be effectively attained where the law allows the company not to disclose the relevant information to employees so as to enable them make informed decisions. Understandably, a company might contravene the insider trading provisions where a company fails to disclose materially price sensitive information. However, a majority of the Advisory Committee of the Corporations and Markets Advisory Committee considers that new securities issues and most corporate buy-backs, both of which are already subject to comprehensive disclosure requirements, should not also be subject to the insider trading prohibition.\textsuperscript{157} A majority of the ‘CAMAC’ Committee posit that buy-backs do not come within the insider trading law. The writer discounts the views of ‘CAMAC’ by suggesting that current and former employees be adequately informed by the disclosure of all information relating to the buy-back and not only information relation to ‘price’ and, that the insider trading provisions and s 995\textsuperscript{158} should be evoked where there is a misleading price sensitive information.

\textsuperscript{155} An Australian listed company must also lodge Form App 3D if there is any change to information provided in the Form App 3C.

\textsuperscript{156} See, \textit{Perry v Bundaberg Foundry Co Ltd} [1933] St RQ d 139.


\textsuperscript{158} This section deals with misleading and deceptive conduct.
2.3.2.5. Selective Buy-Back.

Section 9 defines a selective buy-back as one that is not an equal access scheme buy-back, or a minimum holding buy-back, or an on-market buy-back, or an employee share scheme buy-back. Section 257D (1), requires the terms of a selective buy-back agreement to be approved either by a special resolution passed at a general meeting of the company with no votes being cast in favour by any person whose shares are proposed to be bought-back, or their associates, or a resolution agreed to by all ordinary shareholders at a general meeting (notwithstanding that the buy-back may relate to other kinds of shares). The difficulties of interpreting and applying s 257D (1) like its counterpart, s 256C (2) (a-b) have been judicially considered in Village Roadshow Ltd v Boswell Film GmbH. This case relates to questions as to when a shareholder is able of casting his/her votes for or against a resolution.

Selective buy-backs must adhere to the disclosure provisions under s 257D (2), which require the company to include with the notice of the meeting to approve the terms of the agreement a statement setting out all information known to the company that is material to a shareholder’s decision on how to vote on the resolution other than information which the company has previously disclosed to its shareholders, and which it would be unreasonable to require the company to disclose again. Whether disclosure of previously disseminated information is unreasonable may depend on:

- The time lapse since the dissemination of the information,
- The extent to which the company’s members has changed since the dissemination of the information; and
- Whether the previously disseminated information occurred in a context conducive to its shareholders remembering it.

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159 Section 257D (1) (a) mirrors similarly with s 256C (2) (a) of the reduction of capital regime.
160 Section 257D (1) (b). This is partially consistent with s 256C (2) (b), however, it differs with this section because, where a reduction involves cancellation of shares, the reduction is to be approved by a second special resolution by members of a class.
161 (2004) 49 ACSR 27. (See, s 2.5.2.1 below for facts of case). See also, Re Tiger Investment Co Ltd (1999) 33 ACSR 438; Salter & Ors v Gilbertson & Ors [2003] VSCA 1. For detail analysis of ss 257D (1) (a-b) and 256C (2) (a-b), see the discussion in both buy-back (s 2.5.2 below) and reduction of capital (Chapter 3, s 3.3.2) concerning shareholder protection.
162 Section 257D (2) is similarly worded with s 256C (4) of the reduction of capital regime. The language of the disclosure provision has been question under chapter four, concerning reduction of capital.
Chapter 2.  2.3. Methods & Procedures (Selective Buy-Back)

A company would have to disclose material information which it had not directly disseminated to its shareholders notwithstanding that it may have been reported in the media. This is because it cannot be assumed that all members would have been exposed to, or would have become familiar with, the relevant media reports. ASIC provides certain minimum factors to be provided to shareholders in terms of disclosure. Where the company is listed, information requirements prescribed by the ASX listing rules must also be applied. Where the selective buy-back scheme involves the buy-back of a significant percentage of shares or the holdings of a major shareholder, ASIC believes that the company’s independent directors should consider providing a statement as to whether shareholders should vote in favour of the proposal, particularly having regard to the proposed purchase price. If the consideration is to be non-cash, ASIC cautions directors to have regard to the full range of their duties and obligations. To fulfill these duties, it may be necessary for the directors to seek an independent expert valuation of the non-cash consideration as well as an assessment of the effect on the company and its business of that consideration being paid.

In the US, a corporation’s power to deal selectively in its own shares has emerged as a powerful defensive maneuver available to a board of directors to thwart a hostile takeover threat or to sever its relationship with a dissident shareholder. This type of buy-back has the risk of potential irregularities and abuses. It has the potential for generating ‘greenmail’ or shareholder inequities and therefore requires particular close

164 Ibid per Ipp J.
165 See, ASIC PS 110, above n 141 paras 45-46.
166 See, ASX Listing Rule 3.8A.
167 Refer to ASIC ‘PS’ 110, above n 141.
169 "Greenmail" is a term that describes a corporation’s repurchase of its own stock from one or a small number of shareholders at a premium above market price, thereby eliminating a raiders potential bid for the target corporation, or severing ties with a shareholder that poses a threat to the future policies of the corporation: Unocal Corp v Mesa Petroleum Co, 493 A.2d 946 (Del 1985). It is so called because it is seen as corporate blackmail, with the greenmailer threatening to take over the target company and expel incumbent management unless the target buys him or her out. It involves a purchase of a substantive block of the target companies stock by an unfriendly suitor with the primary purpose of coercing the target into buying back the block at a premium (T. Gardner, "Company Purchase of its Own Shares under the Companies Bill 1990-A Sheep in Wolf's Clothing" (1992) 22 Vic U Wellington LR 159, 163). By buying out a hostile bidder at a premium above market price, directors may defer a takeover, but at a cost to the remaining shareholder since this involves funds belonging to the company(See, Cheff v Maties, 190 A 2D 524 (Del Ch, 1963). (See generally, I. Udchuku & K. J. Smith, "Greenmail: Appropriate Regulation" [1989] CanSLI 313, 315; E. Bielawski, "Selective Stock Repurchases After Grobow: The Validity of Greenmail under Delaware & Federal Securities Law"(1990) 15 Del JCL 95; Macey & McChesney, "A Theoretical Analysis of Corporate Greenmail" (1985) 95 YLJ 13.

regulation. The Corporations Act and ASIC recognized the danger of selective buy-backs by making provisions for special shareholder resolutions and disclosure procedures. However, the s 257D (1) procedures leave a substantial shareholder who is not a party to the transaction to obtain an even larger proportion of the shareholding, perhaps a controlling interest. Such a shareholder is not precluded by s 257D (1) (a) from voting in favour of the proposal to buy-back shares. Where a company makes a targeted repurchase selectively, the company selects the selling shareholder and places others in a remaining group. This may result in improper discrimination between shareholders in the sense that the favoured members are bought out at say, a substantial premium to the market price or true value of their shares. This leads to dilution of the value of the remaining shares. Another instance may be where a company acquires shares at a discount to their true value, thereby, increasing the equity value of the remaining shares at the expense of the vendor shareholders.

Although not all selective buy-backs are tainted by greenmail, there are possible arguments for the prohibition of the payment of greenmail or against a selective buy-back. Firstly, a corporate buy-back selectively from one shareholder or a small group of shareholders at a premium denies all shareholders in the same class of shares equal treatment. The argument is that all shareholders in a single class merit equal treatment, regardless of whether the particular discrimination in issue ultimately serves the target shareholders’ interest. The argument further holds that since a corporation’s selective buy-back or discriminatory self-tender offer are similar to other types of corporate distribution, such as dividends, discrimination among shareholders is not proper.

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170 See, “C&SLRC” Report above n 99, 73. The two principal category of abuses are: managements use of a selective repurchase to buy-out constructive critics of the company and, to pay a premium above market value to favoured members upon retirement of their shareholding (a procedure which the Americans have dubbed ‘greenmail’. The effect of the unequal nature of treatment in a selective buy-back is evident in the US case of Unocal v Pickens, 608 F. Supp 1081 (1988). There, a company had made a buy-back offer to all of the shareholders except one (Mr. T. Boone Pickens—the corporate raider). The object, was to leave Mr. Pickens as the only shareholder of the company which has been stripped of its capital to pay for the exit of all the other shareholders. The action of management in this case won the courts approval.

171 This has been captioned: a back-door takeover” (see, J. Hewitt, “Share Buy-Back for Australian Companies” (1990) 8 C&SLJ 383, 396).

172 This argument accords with writers of Ford’s Principles of Corporations Law. (See, Ford et al, above n 153 at 1148).

Chapter 2.  

2.3. Methods & Procedures (‘10/12 Limitation)

Critics of selective buy-backs in the form of greenmail suggest that the cost of greenmail is passed on to the shareholders due to a decline in the value of the company’s shares after a share buy-back. 174 While the practice of greenmail and selective buy-back may be unfair and detrimental to non-recipient shareholders because it results in the decline of the company’s stock, it is not clear if the shareholder approval provisions under s 257D (1) are appropriate mechanisms to effectively address the issue in question. If the shareholder approval safeguards cannot guard against the circumstance just mentioned above, then, there is a greater risk that remaining shareholders will be prejudiced in the sense that, if the buy-back is effected at a price which is too generous to the sellers, it would increase the burden of corporate debt on remaining shareholders.

Even creditors are affected by a diminished security, especially where a large shareholder is able to exit the company with the proceeds of the sale of shares. In the US, legislation has been introduced in both the House of Representatives and the Senate that effectively amends the Securities Exchange Act of 1934, by containing provisions that would prohibit a corporation from repurchasing its own shares at a premium from a shareholder who has held over 3% of the outstanding shares for less than two years, unless the offer is made to all shareholders of the same class of stock. In addition, legislation has been proposed in the Senate which would limit the time period a greenmailer is required to hold stock-to six months. 175

2.3.2.6. The ‘10/12’ Limitation.

Another pre-condition adopted by the current legislation, which affects most of the various types of buy-backs is that the buy-backs conform to the “10/12 limit”. 176

175 See generally, Senate 1323, 106th Cong, 1st Sess (1998). House of Representative 5693, 98th Congress, 2nd Session (1998), Senate 2851, 98th Con 2d Sess (1998)). Although a comparable legislation is not available under the Corporations Act, it is suggested that the Australian law can adopt this US approach in addressing problems of greenmail. In addition, the current s 257D (1) shareholder approval legislation may be made subject to the s 232 oppression remedy procedure as superceded requirements.
176 Corporations Act 2001 (Cth), s 257B (4-5). See also s 257C which provides for certain other conditions relating to the 10/12 limit. Cf the 2nd EU Directive, above n 29 Art 22, which implemented the 10/12 limit, requiring that neither the company nor any of its subsidiaries may hold more than 10% of the companies subscribed capital at the same time. (It also required companies to acquire only fully paid up shares). (Contra the 2nd EU Directive, article 19(1) (d)). While some European Member States make provision of the 10/12 limit in their buy-back legislation, the English Companies Act 1985 makes no reference to the 10/12 limit. Contra the situation in other
Chapter 2.  

2.3. Methods & Procedures ('10/12 Limit')

The '10/12' limit sets an upper limit on the quantity of repurchase within the yearly mandate. It applies where a company buys-back shares in an equal access scheme, an employee share scheme or an on-market buy-back. It refers to 10% of the smallest number, at any time during the last 12 months, of votes attached to voting shares.\textsuperscript{177} Other than an on-market or minimum holding buy-back, the procedures vary according to whether a company exceeds the 10/12 limit. A proposed buy-back would exceed the 10/12 limit if the number of votes attaching to:

- All of the voting shares in the company that have been bought back during the last 12 months
- The voting shares that will be bought back if the proposed buy-back is made would exceed the 10/12 limit.\textsuperscript{178}

Where a buy-back relates to non-voting shares such as most preference shares, it cannot cause the acquiring company to exceed the 10/12 limit. Where, as a result of a buy-back being made, the company would exceed the limit of 10% in 12 months, either the terms of the proposed buy-back agreement must be approved by an ordinary resolution at a meeting of the acquiring company unless the buy-back is a minimum holding or selective buy-back.\textsuperscript{179} The approval must be given before the buy-back is entered into unless the buy-back agreement is conditional upon such approval.\textsuperscript{180} For purposes of an On-market buy-back, since it cannot be made conditionally, the terms of the on-market agreement would have to be approved in advanced. Furthermore, under an on-market buy-back, the general meeting could fix limits as to market price or could give discretion to the directors as to limits.\textsuperscript{181} In an equal access scheme, the general meeting could review all the terms of the agreement and could require a price to be specified if the meeting was not content to approve the directors having discretion. In an employee share scheme, there is less control by the general meeting on the terms because the original employee share acquisition scheme may fix many of the terms of the buy-back.

\textsuperscript{177} Corporations Act 2001 (Cth), s 9 and s 257B (4).
\textsuperscript{178} Ibid s 257B (5).
\textsuperscript{179} Ibid s 257B(1).
\textsuperscript{180} Ibid s 257C(1).
\textsuperscript{181} See, Ford et al., above n 153 at 1149. For a demonstrated illustrations of the 10/12, limit and voting procedures, see, J. Hambrook, above n 138 at 2.6.0375.
2.3. Methods & Procedures (‘10/12 Limit)

The 10/12 limit is assumed to be a safeguard against abuse of the buy-back power in the sense that a company may not purchase more than 10% of its shares within a 12 month period unless this is approved by ordinary resolution of the members of the company before the company enters into the purchase agreement. The abuse lies in the fact that if the repurchase occurs in a depressed market, the company is able to buy-back its shares at a price substantially lower than that at which the shares were originally sold by the company. The 10/12 limit also serves the very useful purpose of discouraging ‘going private transactions’. The limitation ensures that the company is not able to acquire enough shares to go private.

Generally, while the legislation appears to be more liberal in that no shareholder approval is required if the repurchase does not exceed the 10/12 limit imposed by law, questions may arise as to whether repurchased shares must be fully paid up, and whether there is any limit to the number which may be purchased. If there is no limit as in a minimum holding and selective buy-backs, it is theoretically possible that the company’s membership will be reduced to zero. The Corporations Act unlike some foreign jurisdictions permits companies to issue both fully and partly paid up shares. By implication, shares could be bought-back either fully or partly paid-up. Arguably, when a company issues partly paid shares, there is a likelihood of some shareholders being adversely affected through discrimination in the procedure of repurchase. Though the 10/12 cap is applicable to both fully and partly paid shares depending on the type of companies, in the case of partly paid shares, the raising of capital will be imperiled because the company only holds a claim against itself. Such a buy-back may impair the creditor’s margin of safety against the business losses incurred by the company. Nothing of value to creditors takes the place of the shares repurchased except what is in reality an un-issued share, as there is no certainty that additional shares can be sold in the future.

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182 The “C&SLRC” Report, above n 96, para 54 posited that (the 10/12 limit will act as adequate checks in the legislation on misuse of the buy-back power, protecting creditors and shareholders).
183 “Going private” describes the process, or a transaction, whereby directors of a public company repurchase sufficient shares of the company to enable it to become a private company, thereby, enabling it to effect an informal conversion without complying with certain requirements. (Refer to, T. Gardner, “Company Purchase of Own Shares Under the Companies Bill 1990- A Sheep in Wolf’s Clothing” (1992) 22 VUWL R 159, 160).
184 See, P. Nobel, “A Cautious Approach to Share Buy-Backs” (1999) 20 Co Law 308, 309. However, because the Act requires a minimum number of members, membership will never be zero in Australian case.
185 Cf Canadian Business Corporations Act 1990, s 25(3) and the English Company Act 1985, s 159(3).
186 See, s 257B(4).
Chapter 2.  

2.4. Policy Issue (Status & Validity of Shares)

This shrinkage of the company's capital base threatens particularly the unsecured creditors whose de facto security is the liquidation value of the company's net marketable assets. If partly paid shares have a detrimental effect on creditors, then shares to be bought back need to be fully paid-up, otherwise the creditors would lose a valuable asset on liquidation namely, the uncalled capital. If this is enforced by effective civil and criminal liability, it will ensure that there is no erosion of the capital maintenance doctrine. However, the flexibility to shareholders and the company through partly paid shares makes the Australian approach more preferable.

While s 257B (4) and (5) to some degree provides a method in calculating the 10/12 limit, the 10/12 limit it may be argued appears to be conservative and reflect the policy that the protection of creditors should not be compromised. Because the 10/12 limit is not applicable to all types of buy-backs it might imply that such a limit may generate some agency problems for example, raising the costs of dispute amongst shareholders and making it difficult to overcome deadlock.

2.4. Some Policy Issues.

2.4.1. Status and Validity of Shares Bought-Back.

In accordance with s 257H (1), once a company has entered into a buy-back agreement to purchase any of its shares, all rights attaching to the shares are suspended, pending either registration of their transfer to the company at which time the shares are cancelled or the termination of the agreement at which time the suspension of the voting rights attaching to the shares is lifted. Once a company becomes the registered owner, the shares are cancelled by force of law. Within a month of a company registering itself as the owner of shares it has bought-back, the company must lodge with ASIC a notice which states

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187 Though fully-paid shares may be just as threatening to creditors as a purchase of partly shares, the danger is not so apparent when shares are bought-back partly paid. If the Australian legislation takes the lead of the Canadian jurisdiction by making it unlawful for companies to buy-back partly paid shares, the raising of capital might not be easily impaired.


189 No period within which the transfer must occur has been prescribed (see, Re George Raymond Pty Ltd (2001) 19 ACLC 553 per Byrne J).

190 Section 257H (3). Comparatively, in the U.S. for example, when a buy-back is effected shares are not cancelled but held in treasury for resale. The main argument for allowing companies to hold repurchased shares in treasury is that it could give companies additional measure of flexibility, which enable companies to manage effectively.
the number of shares cancelled; the class of shares at which each cancelled share belonged; and the amount paid by the company (in cash or otherwise) for the shares.\footnote{191} A company must not dispose of shares it buy-backs.\footnote{192} An agreement entered into by a company in contravention of the above prohibition is void irrespective of the knowledge or intent of the other party to the agreement. In \textit{Bateman v New Haven Park Ltd},\footnote{193} Barrett J noted that there is no express requirement for the execution and delivery of a proper instrument of transfer of the shares by the vendor in favour of the acquiring company.\footnote{194} However, under s 257H (3), the need for such a transfer is implicit in the legislative scheme. Although a share buy-back has some of the characteristics of a sale and purchase transaction in the sense that it is consensual, it is anomalous that rights attaching to the agreement are suspended for policy reasons and cannot be dealt with.\footnote{195} The ‘buyer’ who according to normal contractual and sale contracts, has no capacity to enjoy the property purchased in the same manner as the ‘seller’.

In \textit{Coles Myer Ltd v Cmr of State Revenue},\footnote{196} the Court of Appeal of the Supreme Court of Victoria held that in a selective buy-back, the company did not acquire substantially the same rights as the selling shareholder had before the transaction took place, and therefore the implementation of the buy-back did not attract stamp duty as a transfer of marketable securities. However, in \textit{Re George Raymond Pty Ltd},\footnote{197} it was held that where the parties to a deed had agreed that one would sell shares to the other or their nominee,
and the buying party nominated the company as purchaser, it was held that a buy-back was a sale and purchase for the purposes of the deed. The important point was that title would pass from seller to buyer for an agreed price. The fact that the buyer (the company) was unable to enjoy the thing purchased in the same way or to the same extent as the seller was beside the point. It is submitted that for a contract to be valid, there must be mutuality of obligation or other contractual obligations.\textsuperscript{198} If a contract is not binding on the purchaser (the company) then it should not likely be binding on the seller (shareholder). Since an agreement to buy-back its own shares might not, because of s 257H, be binding on the company, its promise to perform the contract could be illusory. The consequence is that the contract or agreement should not be binding upon the shareholder. Where at the time of performance the financial restrictions (or other factors) prohibiting repurchase, the doctrines of breach, illegality, impossibility and frustration of purpose invite a wider range of possible resolutions ranging from specific performance against the company to cancellation of the entire contract.\textsuperscript{199}

Supervening insolvency may also affect a contract or executory contract for a share buyback. In the U.S case of \textit{Topken, Loring and Schwartz, Inc v Schwartz},\textsuperscript{200} it was held by the New York Court of Appeals that because a ‘buy-out’ agreement against a retiring shareholder might not have been binding on the company owing to the conditions of insolvency prevailing at the time of performance, the agreement was, likewise, not binding on the shareholders, so that the company was unable to enforce the buy-out agreement. The agreement was a contract not mutually binding. It is suggested that if the Australian law should adopt the lead taken from the above statutes, intended to take care of any legal difficulties arising from the doctrine of mutuality of obligations in this way, this will remove any doubt relating to the validity of a contract to buy-back shares.

\textsuperscript{198} It is recognized that the legislature surely overrides common law requirement of mutuality of obligation. However, it is less clear if it applies to contractual obligations.


\textsuperscript{200} 163 NE 735 (NYCA 1928). Even though this case has been criticized and is thought to be unsound (see, L. Getz, “Some Aspects of Corporate Share Repurchases” (1974) \textit{Utah Col LRR} 9, 30)), several jurisdictions have enacted statutory provisions to overcome its effect by specifically providing that a contract for the repurchase of the company’s shares will not be invalid and unenforceable merely because of the possibility of the company’s not being able to comply with the test of liquidity or solvency. (See generally, CBCA 1985, s 40(1), which specifically provides that a buy-back agreement is enforceable against the company except to the extent that the company cannot perform the contract without being in breach of the solvency requirement). Similarly, see, \textit{New Zealand Company Act} 1993, s 67(1).
Chapter 2.  

2.5. Creditor & Shareholder Protection

2.5.1. Creditor Perspective:

The legislative litmus test for any share buy-back is set out in s 257A, namely that a company may buy-back its own shares if:

(a) the buy-back does not materially prejudice the company’s ability to pay its creditors, and
(b) the company follows the procedures laid in ss 257A-257J.

Section 257A reveals two issues. First, the interests of creditors are given explicit legislative recognition, and second, there are procedural steps that the law has mandated must be followed if a share buy-back is to succeed. Some related provisions are signposted by s 257J, which alerts companies and their officers to matters such as if the buy-back involves a reduction of capital and the company fails to follow the procedures in Ch 2J.1 Div 2.

2.5.1.1 Director and Shareholder Liability

If a company buys-back its own shares and contravenes s 257A (a), the buy-back is unauthorized by law and thus contravenes s 259A. The contravention does not affect the validity of the acquisition and the company is not guilty of an offence. However, any person who is involved in the company’s contravention also contravenes s 259F (2) which is a civil penalty provision. ASIC, or a person whose interests are affected, may seek an injunction and damages under s 1324 to restrain the company from contravening s 259A.

For the purposes of s 1324(1A), if s 257A (a) is contravened then the interests of creditors and members of the company are taken to be affected by that conduct. To protect creditors against improvident buy-backs, the law extends s 588G to impose personal liability for the debt created by entry into a buy-back on those who are directors when the agreement is entered into if after the agreement the company is insolvent.

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201 Ibid s 259F (1).
202 Directors here refer to those who voted for or consented to a resolution authorizing the back-back.
203 Corporations Act 2001 (Cth), s 588G. Although not explicitly stated, the director liability provisions combine both the directors’ duties provisions (ss 180-184) and the insolvent trading provisions (s 588G). The conditions for application of s 588G are being a director when the company incurred the debts; there being reasonable grounds for suspecting insolvency. The effect is to expose directors who authorize such transactions to both criminal and
Chapter 2.  

2.5. Creditor Protection (Director's Liability)

Under s 588G, a corporation's directors\textsuperscript{204} contravene that section if they allow a company to buy-back its own shares under s 257A when the company was insolvent or became insolvent as a consequence of the buy-back\textsuperscript{205} Section 1317H allows the court to order the directors to compensate the company where on the application of the civil penalty order the court is satisfied that the directors have contravened s 588G and the company had suffered loss. This provision may seek to protect creditors especially where the corporation is empowered to purchase and maintain insurance for the benefit of its officers and to indemnify them against liability if they acted honestly and in good faith. To permit the company to buy-back its own shares where it is insolvent would prejudice the company's creditors. This is because funds that would otherwise go towards satisfying the debts owed to creditors would, through a repurchase, be returned to the company's shareholders.

However, though a director who has breached s 588G may be subjected to civil or criminal liability, there is, arguably, no real need for an explicit provision enabling a director who has satisfied the necessary statutory conditions to obtain a contribution from a fellow director, although such a provision is usually inserted in most overseas legislation.\textsuperscript{206} Moreover, most actions against directors must be commenced within a certain time frame from the passing of a resolution authorizing the transaction.\textsuperscript{207}

Furthermore, the fact that laws impose fiduciary duties on directors also seems to exonerate them from liability especially if they can rely on their statutory 'business judgment rule' and on good faith. It is possible that in such circumstances, creditors will have to suffer alone if the courts were to come to the decision that directors did not breach their statutory and common law fiduciary duties and duties of care and

\textsuperscript{204} civil liability when s 588G is not complied with. Section 588G(2) is a civil penalty provision (which include a pecuniary penalty under s 1317G; a disqualification order under s 206C and a compensation order under s 132171)(See. Official Trustee in Bankruptcy v CS & GL Hauhby Pty Ltd (1989) 21 FCR 19).

\textsuperscript{205} Directors here refer to those who voted for or consented to a resolution authorising the back-back.

\textsuperscript{206} Corporations Act 2001 (Cth), s 588G (1-2).

\textsuperscript{207} For example, see, ss 118 (2) (a) & 118(3) of CBCA. According to this provision, contribution is however only obtainable from those directors who had voted for or had consented to the unlawful act.

\textsuperscript{207} See for example, s 113(7) of the CBCA which imposes a time frame of two years within which proceedings may be brought against the directors.
diligence. The general principle of organic theory which divides power between the
board of directors and members in general meeting and (directors’ inter se) may pose
difficulties as to who is a director and when a director may be liable for authorizing a
buy-back. Though s 9 defines a ‘director’, difficulties of interpretation may cast doubts as
to when a director becomes liable under s 588G. If, for example, directors authorise a
buy-back and a director though present in a meeting of directors did not vote for the
authorization can such a director raise the defense of non participation or, that he/she
took reasonable steps to persuade the others to prevent the occurrence of a debt?
Although s 588G seems not to apply to those persons who did not take part in
management of the company, the wide definition of directors would capture even de facto
and non voting directors. Obviously, the section 588H defences may also make it
difficult for creditors to receive any payment in the form of compensation where directors
successfully evoke the defence provisions.

It is suggested that specific and explicit provisions should be made that the liability of the
directors applies only to those directors who consented to or voted in favour of the
resolution to acquire the company’s shares if the company, is or becomes insolvent as a
result of the buy-back. Arguably, while it is prudent for directors in breach of the buy-
back legislation to be liable to the company and its creditors to make good the amount of
the loss from the company’s capital, for the provision to be effective, the situation when a
director can be held liable for rendering the company insolvent needs to be certain.

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208 A ‘Business Judgment Rule’ (“BJR”) is a presumption that in making a business decision the directors of a
corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best
interest of the company. Though the business judgment rule might not apply to buy-backs, the directors will not be
penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was
made. It may be argued that if the “BJR” is not rebutted, then the protection afforded by the
director’s liability provisions or solvency requirements may be defeated.
209 Cf Standard Chattered Bank of Australia v Antico (1995) 18 ACSR 1; FAI Traders Insurance Co Ltd v Ferrara
210 This suggestion is in line with s 118 of the CBCA 1985, ss 8-33 of the RMBCA (1984) which both impose
personal liability on those directors who voted for or assented to a share buy-back in breach the solvency and
liquidity test.
211 Case law has provided certain guidelines in determining when a company is insolvent or when there are
reasonable grounds for suspecting insolvency (see. ASC v Forem-Freeway Enterprises Pty Ltd (1999) 30 ACSR
634; Credit Corporation Australia Pty Ltd v Akin (1999) 29 ACSR 727; Kenna & Brown Pty Ltd (in liq) v Kenna
(1999) 32 ACSR 430. However, they still pose many difficulties.
Chapter 2.  2.5. Creditor Protection (Solvency Cushion)

Closely linked to the protection of creditors is the liability imposed on vendor shareholders making them liable to refund money or return property to the company or to indemnify another person. Shareholder’s liability is limited to an amount not exceeding the amount paid for its shares.\textsuperscript{212} While this protection is certain where the vendor shareholder can be identified, it is inapplicable in cases of market buy-backs where shareholders are not easily identifiable except where such a shareholder was the sole shareholder to sell shares on the market on the day on which the company made the buy-back.\textsuperscript{213} If this was to happen, then it may give an undue advantage to shareholders in public listed companies over those members in a proprietary or unlimited company. The positions of the recipient shareholder of unlawful distribution, under s 254T have been very problematic with the courts delivering conflicting judgments.\textsuperscript{214}

2.5.1.2. Protection from the Solvency Test

The test of insolvency deduced from s 588G is inability to pay debts as and when they become due and payable.\textsuperscript{215} The legislation (i.e., s 257A) does not expressly relate buy-backs to a solvency requirement, but, s 257J (Item 1)\textsuperscript{216} provide that the directors would have to compensate the company if the company becomes insolvent after entering into a buy-back. Accordingly, the primary source of creditor protection will be the deterrent effect of personal director’s liability for allowing the company to trade whilst insolvent under s 588G. A company that buys-back its own shares will incur a debt under s 588G (1A) from the time the back agreement is entered into.\textsuperscript{217} Comparatively, unlike the English legislation which specifies that buy-backs can only be made from distributable profits,\textsuperscript{218} and the Canadian\textsuperscript{219} and New Zealand\textsuperscript{220} jurisdictions

\textsuperscript{212} Refer, to s 259F and Part 4.9B. Cf Company’s Act 1981 (UK), s 58(3-4) (as amended).
\textsuperscript{213} However, where there is a record of the transaction canceling shares, the vendor might not remain anonymous.
\textsuperscript{214} For purposes of the s 254T dividend distribution, see, Segaehoe Ltd v Akka (1990)29 NSWLR 569 where Gilles J expressed some possible ways by which shareholders may be liable for receiving unlawful dividend payments. Cf Towers v African Tag Co [1904] 1 Ch 558; Hilton International Ltd v Hilton [1989] 1 NZLR 442. A detailed analysis of the liability of a shareholder to compensate the company for ‘unlawful transactions’ is provided in Chapter 5 of this study.
\textsuperscript{215} See, section 95A(1).
\textsuperscript{216} Cf’s 1317H.
\textsuperscript{217} Cf section 256E (Item 1) which is similarly signposted for purposes of the liability of directors under a reduction of capital regime. For purposes of s 588G, a company that buys-back shares incurs a debt even if the consideration is not a sum certain in money. The debt is incurred at the time the buy-back agreement is entered into.
\textsuperscript{218} Companies Act 1985 (UK), s 263 provides that the source of funds from which buy-back can be made by public companies must be from distributable profits. See also, ss 162(2) and 168.
\textsuperscript{219} CICA 1990, s 42(2). In Canada like Australia, payments to shareholders through buy-back are not restricted to the
which specifically restrict buy-backs to a solvency requirement, the Corporations Act
does not specifically state that a company must not make a buy-back of its own shares if
it does not meet the solvency test. By implication however, s 257J (Item 1) of the
Australian law imposes liability on directors under s 588G who trade while insolvent.
Insolvency under Australian law refers to the inability of the company to pay its debts as
they become due and payable. Accordingly, the company’s directors must not
authorize a proposed buy-back which will materially prejudice the company’s ability to
pay its creditors or which will render it insolvent.

If the legislation intended the cash flow solvency requirement to be the financial criterion
for a buy-back, why not expressly make it clear by stating that a company should only
buy-back its own shares if the company would be able to meet the solvency test as
applied in comparable jurisdictions? The approach in Australia of making directors liable
for insolvent trading is a good approach but, as argued in this study, there are difficulties
of proving a case against directors for insolvent trading. Furthermore, even if the law
contemplates the ‘cash-flow’ test, proving that creditors debts have not been paid,
standing alone, does not establish insolvency. It would be more preferable if the
Canadian or New Zealand approaches of a dual solvency test had been adopted.

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profits rule. In Canada, a company may only acquire its own shares if there is reasonable belief that the company
is, or would be after the buy-back, able to pay its debts as they fall due and payable (cash-flow test) and the
company’s assets would, after the acquisition, exceed its liabilities (balance sheet test). See a similar situation
in South Africa, s 90 of the Company Amendment Act 1999 (now 2001) which makes buy-back a subject to a dual
solvency requirement.

Corporations Act 2001, s 588G (1) (This is a cash flow solvency test). Proponents of the cash flow theory argue
that the balance sheet test is not productive or indicative of a company’s insolvency, because though the balance
sheet test shows a company’s assets and liabilities at a particular time, it does not show the viability of the
company. Thus, in Quick v Studland Pty Ltd (1998) 29 ACSR 130 at 139, Emmett J held that a company may have
an excess of assets over liabilities, but its assets may not be readily realizable for payment of debts as they fall
due. (It is important to consider the solvency arguments together with Chapter 8, below, section 8.3.1 where
arguments for and against the cash-flow and balance sheet tests are discussed in detail).

According to s 95A (A) of the Corporations Act, a person is insolvent if, and only if, the person is able to pay its
debts as when they become due and payable. A test as to whether a company is insolvent relates to
liability because the legislation is concerned with the failure of a unit in a trading environment. The ‘balance
sheet’ test does not apply here because the basic question is whether the business is viable.

Section 95A requires ascertainment of the company’s existing debts, its debts within the near future, the date each
will be due for payment, the company’s present and expected cash resources. (Refer to, Bank of Australasia v Hall
(1907) 4 CLR 1514; TNC Channel Nine Pty Ltd v Scourney (1995) 18 ACSR 393). The cash-flow approach
standing on its own may be problematical. Firstly, a ‘dying company’ may still be able to meet its debts as they
become due though its debts exceed the value of its assets. It is also possible to envisage circumstances where that
test could technically be made notwithstanding the fact that on an alternative definition of insolvency (the ‘balance
sheet’ test-liabilities exceeding assets), the company is actually hopelessly insolvent. (See, generally, R. Kesler,
“Share Purchases under Modern Corporations Law” (1960) 28Fordham L R 737, 764.). Contra generally, s 257A
Chapter 2.  

2.5. Creditor Protection (Solvency Cushion)

The insolvency tests in these jurisdictions are a cumulative dual solvency requirement. Accordingly, a company is prohibited from buying-back its own shares if before and after the buy-back transaction the company would not be able to pay its debts as they become due (the cash flow test) and, the company’s aggregate net assets would be lesser than or equal to its aggregate net liabilities (balance sheet solvency). If either alternative applies, the corporation is prevented from acting.\textsuperscript{224} Presumably, to permit a company to buy-back its own shares where it is insolvent would prejudice creditors. This is because funds that would otherwise go towards satisfying the debts owed to creditors would, through a repurchase, be returned to the company’s shareholders.

Though the Corporations Act contemplates solvency, it is however unclear whether solvency of a company should be measured both at the time when the contract to buy-back was entered into and at the time when the contract was performed. Though s 259F prescribes the consequences of failing to comply with s 259A, it is not expressly clear whether buy-backs made under the above situation would render the purchase void or voidable.\textsuperscript{225} Instead, control is achieved by imposing civil and criminal penalties on any director or officer who approves or authorizes the buy-back at the time when there are reasonable grounds for suspecting that the company is insolvent or would so become insolvent.\textsuperscript{226} While it would be prudent to adopt a dual solvency approach,\textsuperscript{227} it would equally be important that the acquiring company must be required to meet the solvency

\footnotesize{\textsuperscript{224} See, \textit{Canadian Business Corporations Act 1990}, (CBCA) s 42; and \textit{Delaware Corporation Act 1985}, s 160(a) (1). Under \textit{New Zealand Company’s Act 1993}, s 4 (1) (a-b) prescribes a dual solvency tests which includes the similarly worded Australian ‘cash-flow test’ (inability of the company to pay its debts as they become due). But, there is a second test in both Canada and New-Zealand, based on the state of the company’s balance sheet ‘balance sheet test’ (buy-back is prohibited if a company’s aggregate net assets would be lesser than or equal to its aggregate net liabilities).

\footnotesize{\textsuperscript{225} It is submitted that the critical question should be whether the company is able to pay its debts and, therefore, being insolvent at the start of the buy-back agreement should not automatically render the contract unenforceable. Several jurisdictions have however enacted statutory provisions specifically providing that a contract for purchase of a company’s own shares will not be invalid or unenforceable merely because of the possibility of the company being unable to comply with the solvency or liquidity tests. (See, for example, \textit{CBCA 1990}, s 40(1)). This view is also consistent with Australian case law under s 588G where insolvency is interpreted to refer to whether the company is actually paying its debtors. (See, \textit{Bank of Australasia}, above n 223; \textit{Sandall v Porter} (1966)115 CLR 666 at 670). (See also the explanation provided by, L. Getz, “Some Aspects of Corporate Share Repurchases” (1974) 9 \textit{U Bri Col LR} 9, 30).

\footnotesize{\textsuperscript{226} \textit{Corporations Act 2001}, s 588G (1) (c).

\footnotesize{\textsuperscript{227} Dual Solvency requirements are a form of creditor protection in the U.S., Canada and New Zealand. This ensures that buy-back does not render a company unable to pay its debts either in the short term in the form of liquidity problems, or in the short medium term in the form of external liabilities exceeding assets. (see, \textit{CBCA} s 42 and,}
requirements only after the buy-back transaction.\textsuperscript{228} This is consistent with Foster J in \textit{Robinson v Wangermann} where he said:

\begin{quote}
It is immaterial that the corporation was solvent and had a sufficient surplus to make payment when the agreement was entered into. It is necessary to a recovery that the corporation should be solvent and have sufficient surplus to prevent injury to creditors when the payment is actually made.\textsuperscript{229}
\end{quote}

Although creditor protection would need to go beyond the solvency tests, a company incurs a debt under s 588G (1A), and directors’ liability is triggered under s 588G(1), at the time when there are reasonable grounds for suspecting that the company is insolvent (which presumable is after the buy-back transaction). It is less important if the solvency test is prejudicial to creditors under s 257A (a) at the start of the buy-back. What is important is whether after the buy-back transaction, the company is solvent and creditors’ debts can be satisfied.

\section*{2.5.2 Shareholder Perspective.}

\subsection*{2.5.2.1 Protection under the Shareholder Approval provision}

The special shareholder approval provisions under s 257D (1) which mirror those of s 256C (2) (a-b), are intended to protect shareholders from share capital transactions which may detrimentally affect their interests. Shareholders generally, may be prejudiced both under a buy-back and a reduction of capital when the company either buy-back its shares selectively,\textsuperscript{230} or reduces its capital selectively.\textsuperscript{231} A selective buy-back as noted

\textsuperscript{228} NZCA 1993, s 4). The dual approach offers a more effective model. For a detail analysis of the dual approach, see, chapter 8, below.

\textsuperscript{229} The New Zealand rules are based on a company being solvent at the time a transaction takes place and places an obligation on the board to ensure that the company will satisfy a solvency test at the time. The solvency test which is an adoption of the 'dualist' approach of insolvency is satisfied if the company can pay its debts as they become due in the normal course of business and the value of the company’s assets is greater than the value of its liabilities including contingent liabilities (\textit{Companies Act 1993} (NZ), s 4(1) (b)). Cf South African approach to its \textit{Company’s Amendment Act 2001}, ss 85-90. See, F. H. Cassim. “The New Statutory Provisions on Company Share Repurchases: A Critical Analysis” (1999) 116 SALJ 760, 771, where in analyzing the statutory provisions of the current South African buy-back regime, took the view that the requirement of solvency should be ascertained before and after the share purchase transaction.

\textsuperscript{230} 75 F 2d 756, 757 (1935). See also, \textit{Re Fecheimler Fischel Co}. 212 F 357 (2\textsuperscript{nd} Cir 1914). There a shareholder had sold his shares to the company in return for a promissory note given by the company. The promissory note was given in good faith at a time when the company was solvent. The court held that the promissory note would be unenforceable as against other creditors of the company if the company was insolvent at the time of maturity of the promissory note. The court ruled that the fact that the company had a surplus when the note was given was not decisive of the case if it was insolvent when the time of payment arrived.

\textsuperscript{231} \textit{Corporations Act 2001} (Cth). s 257B.

\textit{Ibid} s 256B (2).
previously, presents the danger that the company may offer to selected shareholders especially favourable terms which are not available to other shareholders. This danger is mitigated by safeguards under the so called ‘shareholder approval provisions’ under s 257D, by taking away from the interested shareholders the power to vote in favour of a resolution which apparently benefits them. Section 257D(1) requires that the terms of a selective buy-back agreement must be approved either by:
(a) a special resolution passed at a general meeting of the company, with no votes being cast in favour of the resolution by any person whose shares are proposed to be bought-back, or their associates; or
(b) a resolution agreed to, at a general meeting, by all ordinary shareholders; or the agreement must be conditional on such an approval. This is so even if the buy-back relates to shares other than ordinary shares.

The procedures raise matters which have been judicially questioned but not adequately answered. In No 5 Lorac Avenue Pty Ltd v Brooke, it was questioned if a resolution can be said to be approved by all ordinary shareholders at a meeting if some ordinary shareholders either did not attend the meeting, or attended but abstained from voting on the resolution. The Full Court of the Victorian Supreme Court held that a resolution may be said to have been passed unanimously if no person present at a meeting vetoed it. In a similar context, under s 256C (2) concerning a reduction of capital, Santow J said that ‘unanimity of all ordinary shareholders at the meeting was required.’

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232 See, section 2.3.2.5. above, where a selective buy-back is discussed.
233 The objective in having the company approve certain buy-backs in general meetings is to keep the members fully informed. To this end, s 257D (1) must be read together with other procedural requirements which include: ss 257D (2-4) governing information to accompany the notice of meeting, (s 257D (2); documents to be lodge with ASICs 257D (3). These approval provisions must also be accompanied by s 257G ‘disclosure’ provisions. Cf Browne v Panga Pty Ltd (1995) 17 ACSR 75. See also, ASIC minimum information requirements, in ASIC Practice Statement (PS) 110: Share Buy-Backs (Para 42) which is to effect that the notice of meeting must contain a great of information. If the scheme for selective buy-back is in non-cash consideration, ASIC cautions directors to have full range of their duties and obligations. Part of their duties is to seek an independent expert valuation of the non cash (see, ASIC ‘PS’ 110, para 43, 57-9). Section 1324 –injunction provision must also be looked into. It will also be important to read s 257D together with s 256C (shareholder approval provisions under s selective reduction of capital).
234 Cf s 256C (2) which requires that where a resolution for reduction of capital involves preference shareholders whose shares are to be cancelled, the reduction must also be approved by a special resolution of those members.
236 Re Etrade Australia (1999) 30 ACSR 516.
Chapter 2. 2.5. Shareholder Protection

In *Re Tiger Investment Co Ltd*, 237 his Honour thought that the reference to all ordinary shareholders presumably meant those ordinary shareholders who are present in person or by proxy, and who voted at the meeting. ASIC believes that the resolution must be approved by all ordinary shareholders in the company. 238 ASIC may exempt a company from the operation of s 257D. 239 According to ASIC, it may allow buy-backs to be approved otherwise than at a shareholders’ meeting if the requisite number of shareholders approve the terms of the buy-back in writing in some other way, for example, by signing a document or endorsing a facsimile. 240 According to the writer, the preferable interpretation for s 257D (1) (b) is that taken by Santow J in *Re Tiger Investment*. The effect is that all of a company’s members may have to attend a meeting, and vote in favour for the resolution before the section can effectively take effect.

The most noticeable difficulties can be gleaned in the construction of both s 257D(1)(a) and s 256C(2) (a). The question in issue was whether those persons precluded from voting in favour of a resolution can alternatively vote in favour of it. In *Village Roadshow Ltd v Boswel Film GmbH*, 241 a company with both ordinary and preference shareholders purported to buy-back all of the shares of the preference shareholders selectively and compulsorily. According to the company’s constitution, two meetings had to be held to selectively buy-back any shares of members. The buy-back was also to conform to s 257D (1) (a). The various meetings were both held and resolutions passed but problems arose with the procedures. The problems range from questions as to whether s 257D prevents a person whose shares are proposed to be bought-back under a selective buy-back from voting against the special resolution under s 257D(1)(a) and, whether an irregularity in the resolutions under s 1322, invalidates the meeting to approve the buy-backs.

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238 ASIC ‘PN’ 110, above n 141 para 9.
239 Corporations Act, s 257D (4).
240 ASIC ‘PS’ 110, above n 141 paras 18-19. ASIC may allow associates of a selling shareholder to vote on the approval resolution where the association is merely technical (para 23).
241 (2004) 49 ACSR 27 at 33-34. This view is consistent with that of ASIC who asserted that while s 257D (1) prevented shareholders from voting in favour of the buy-back resolution, it did not prevent them from voting against it.
Chapter 2. 2.5. Shareholder Protection

In *Village Roadshow*, Mandie J held that shareholders were entitled to vote against the buy-back resolution and that s 257D(1)(a) did not prevent either preference or ordinary shareholders voting against. This was confirmed on appeal, where the court held that persons who cannot vote in favour of a special resolution are entitled to vote against it. The preferable approach is that because s 257D(1)(a) is silent on the issue, where the company’s constitution and the legislation confers voting shares to shareholders and directly indicates that shareholders can exercise their rights by voting against a resolution, that should be the correct construction of s 257D(1)(a). Where both the constitution and statute are silent, it is hard to see what would prevent vendor shareholders from voting against a resolution. Generally, most buy-backs of shares, other than ordinary shares, will be by means of a selective buy-back. The legislation does not ensure that the members of a class of shares other than ordinary shares will have any control over the terms of a selective or other type of buy-back relating to those shares. Thus, for example, preference shareholders would have no power to veto a buy-back of their shares approved by ordinary shareholders unless their constitution deems a buy-back to be a variation of their class rights.

As to whether s 257D invalidates an improperly cast vote, it was held in *Village Roadshow* that if a person improperly votes in favour of a resolution, the resolution will not be invalid provided that the person’s votes were excluded when determining whether the resolution had been approved. The conclusion to be derived from the shareholder approval provisions is that the legislation leaves much scope for mischief. It is not a sufficient safeguard that minority shareholders are adequately protected under s 257D.

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243 See, *Salter v Gilbertson* [2003] VSCA 1 where minority shareholders voted against a resolution preventing the requisite majority of 75% to make the resolution effective. The majority shareholders appealed the decision to compel the minority to refrain from voting against any resolution by the company to buy-back their shares. Winnieke P, Phillips and Batt JJ. A thought the minority were barred from voting in favour of a resolution but not against it.

244 *Re Village Roadshow Ltd* (2003) 48 ACSR 167. Similarly, many class rights clauses deem a reduction of capital to be a variation of class rights (see, *Re Northern Engineering Ltd* [1995] 1 BCLR 10.

245 See, for example, *Winpar Holdings v Goldfields Kalgoorlie Ltd* (2000) NSWSC 727, *Re Tiger Investment Co Ltd* (2000) 18 ACLC 62 at 68 where in interpreting s 256C (2) (a) concerning a question as to whether ‘no votes being cast’ could be read literally to invalidate a resolution if a person whose shares were to be reduced selectively was allowed to cast its votes, Santow J, held that if such a vote is cast, it does not go to the validity of the resolution. For the writer’s position on this, see, Chapter 3, section 3.3.2.1., as concerns reduction of capital.
(1) since the provision is not only unclear but difficult to enforce. Minority shareholders in both the buy-back and reduction of capital regimes need more than the shareholder approval legislation to protect themselves. While there is the need for a clarifying legislation of the shareholder approval procedures, shareholders may receive further redress from the s 232 oppression remedy provisions.246

2.5.2.2. Protection under the Disclosure & Insider Trading Provisions.
To reflect the concept of informational transparency, a shareholder should only agree to a scheme of buy-back if he/she had adequate information to determine whether or not to accept the offer made by the company. In the case of an equal access scheme or a selective buy-back, the acquiring company must include with the notice of the meeting a statement setting out all information known to the company that is material to the shareholder’s decision whether to accept the offer.247 ASIC outlines in its Policy Statement 110 certain minimum disclosure information to be provided to shareholders.248 The disclosure obligations, which are supplemented by the ASX for those companies whose shares are listed, are similar to those required in a take-over situation and scheme of arrangement.249 They are further strengthened by sections 995 and 1041H which prohibit a person from engaging in conduct (in connection with any dealing in securities) that is misleading or deceptive or is likely to mislead or deceive. Though these requirements may be thought to be adequate, the exact extent of adequate information is controversial. To enable shareholders to exercise their judgment regarding a proposed buy-back, there is a need to explain the reasons for the proposed buy-back.

246 See, Chapter 8 of the thesis where there is a detail analysis of the oppression provision.
247 See generally, Corporations Act 2001 (Cth), ss 257C (1-3) S 257D (2) & (3). The disclosure approach is consistent with the common law disclosure obligation (see, for example, Fraser v NRMA Holdings Ltd (1995) 55 FCR 452; Bateman v Newhaven Park Ltd (2004) 49ACSR 454 per Barrett J. Like its reduction of capital counterpart, the company does not have to disclose information if it would be unreasonable to require the company to do so because the company had previously disclosed the information to its shareholder. Cf Browne v Panga Pty Ltd (1995) 17 ACSR 75. See, also s 257G.
248 ASIC Policy Statement 110, “Share Buy-Backs” (1995) paras 42-60. These minimum requirements include: the number of shares on issue, the number and percentage of shares to be bought; particulars of the terms of the buy-back; the offer price and a simple formula to calculate the price; reasons for the buy-back; the interest of any director who may participate in the buy-back agreement; the financial effect of the buy-back on the company; the source of the funds for the buy-back; the date the offer will commence and close; for a selective buy-back-the identity of the selling shareholders; the pros and cons of approving the buy-back.
249 Generally, see, ss 1001A and 1001B.
Chapter 2.  

2.5 Shareholder Protection

It is undeniably true that in many cases, the proponents of a share buy-back state their reasons in order to persuade shareholders to authorize the proposed buy-back. There is judicial authority which indicates that directors are under a duty to ‘make a full disclosure of all facts within their knowledge which are material to enable the members to determine upon their action’. This duty to disclose is very similar in scope to the duty of directors to disclose information in the context of both selective buy-backs and selective reductions of capital. However, the various disclosure and notice provisions have specific laeunae. It is doubtful that an omission to state a fact that is relevant to the fairness of a proposal to buy-back would be covered sufficiently by the above disclosure provisions, although, in such cases, an oppressed shareholder or ASIC acting as amicus curia, could invoke the insider trading provisions. Also, while the Stock Exchange requires companies to state the reasons for a buy-back, and criminalizes insider dealings, dealings in the Stock Exchange might trigger insider trading. Moreover, the fact that directors are involved in a disclosure of a proposed buy-back does not necessarily mean that shareholders are fully informed because they may not state the likely impact of the share buy-back on the value of the remaining shares.

The disclosure of information enables shareholders to vote in accordance with their interest. It gives the voting shareholders an important basis on which to make an informed choice. To require an assessment of the impact of a buy-back on share value to be included in a mandatory disclosure would not only enhance transparency and promote the directors’ accountability to shareholders, it would also enhance the safeguarding of minority interests. The disclosure provisions under s 257D (2) make it possible for

250 See, Baffin v Bevanfields Ltd (1938) 38 SR (NSW) 423, 440 (per Long Innes CJ). This case confirms that shareholders must be provided with sufficient information for them to make a considered decision as to whether it is in their interest to participate in a meeting. This test was adopted by Latham CJ in the case of Peters American Delicacy Co Ltd v Heath (1939) 61 CLR 457 at 486 where the High Court considered whether a circular distributed with notices of a meeting to consider a proposed change to the constitution provided adequate information to shareholders.

251 This is because the nature of the various types of duties arises from the same case law. In Re Campaign Holdings (1989) 15 ACLR 762 Pullagar J makes observations about the duty to directors to disclose in the context of selective reductions of capital. In this case, he quotes from Darwall v North Sydney Brick & Till Co Ltd (1989) 7 ACLC 81, where Bryson J refers to Long Innes J’s judgment in the Baffin case (ibid).

252 The better approach is to adopt the views of ASIC, where they stated that if the scheme for a selective buy-back is in the form of non cash consideration, they caution directors to have full range of their duties part of which is to seek an independent expert valuation of the assets. (See, ASIC PS 110, above n 241 paras 43, 57-9).

253 The Corporations Act is silent on the fixing of the purchase price for buy-back. The best obtainable price afforded
enhanced disclosure to be available to shareholders, but they also allow a company not to disclose information which it had previously disclosed to its members. As a result, can a company be liable for insider trading when it possess price sensitive information which is not disclosed? The Australian legislation considers insider trading to be illegal when company directors withhold sensitive information, exposing them to criminal liability. However, it is less clear whether a company that withholds price sensitive information also breaches the insider trading provisions or whether, aggrieved parties may seek relief against the company for insider trading?254

The Australian Corporations and Market Advisory Committee255 recommends that most buy-backs, are already subject to comprehensive disclosure requirements, should not also be subject to the insider trading prohibition.256 In Exicom Pty Ltd v Futuris Corp Ltd,257 the issue was whether a company could be an insider to issue of its own securities. Young J held that unissued securities were outside former section 1043. He noted that the Court of Appeal in Hooker Investments Pty Ltd v Baring Bros Halkerston & Partners Securities Ltd (No 2)258 had regarded earlier insider trading legislation in the Securities Industry (NSW) Code as being directed to people who are trading in the market place. His Honour, intimated that a company in relation to issue of its own shares was not an insider. In Canada, a company that withholds price sensitive information is considered an insider and is prosecuted as such.259 Not disclosing price sensitive information to shareholders has the same effect as not disclosing full and frank information to enable them make an

by directors does not always reflect any fair or equal dealing. The best price for a company to buy-back its own shares is not necessarily the best price for the selling shareholders. What is of critical importance for shareholders is the access to information concerning the price of the share. Though the legislation and ASIC seek to attain this objective, similar provision is not available to creditors of the company whom the capital maintenance doctrine has as its primary objective – their protection. One commentator suggested that creditors should consider it desirable to insert clauses in their lending agreements requiring their approval before borrowing corporations could enter into any buy-back transactions (see, L. Factor, ‘Capital Maintenance: Simplification and Creditor Protection’ (1995) 5 AACL 259, 273). For comparative views on the disclosure requirements in other jurisdictions see, F. Mundheim & Murphy, ‘An Initial Inquiry into the Responsibility to Disclose Market Information’ (1973) 12 U Pa LR 798, 842;

254 Cf Hooker Investments Pty Ltd v Baring Bros Halkerston Ltd (1986) 10 ACLR.
256 Ibid.
2.6. Conclusion.

The law has made significant inroads to the buy-back legislation in certain material respects, however, it is still lacking in other ways. At the very least, lack of an express financial criteria and the questionable nature of the shareholder approval provisions, make it very difficult to address important issues relating to buy-back and the protection of creditors and shareholders. There is much scope for clarity and precision in the current law. There are a number of minor ways in which the law can be improved. These include, expressly making buy-backs conditional on a dual solvency requirement which is reinforced by the insolvent trading provisions and redraft the s 257D special resolution and voting procedures.

260 See for example, Winpar Holdings, above n 232; where in a similar situation of disclosure under s 256C (4), shareholders invoked the s 995 provisions. Underlying the argument in this case was that inadequate disclosure of material information, invalidated the capital reduction since it prevented shareholders in making informed decision as to their votes as required by s 256C(4).

261 Ontario Business Corporations Act 1985, s 152 provides in relation to buy-back and insider trading thus: “Every insider or affiliate of an insider of a company who, in connection with a transaction relating to any share of the corporation or any debt obligation of the corporation makes use of any specific confidential information for the benefit or advantage of himself or of any associate or affiliate of himself, that, if generally known might reasonably be expected to affect materially the value of the shares or the debt obligation is (a) liable to compensate any person for any direct loss suffered by the person as a result of the transaction unless the information was known or ought reasonably to have been known to the person at the time of the transaction…” This provision is only a guidance and not a model because it may also be couched with interpretative difficulties as was observed by the courts in, Greene v Charterhouse Group of Canada Ltd (1973) 51 Can BR 676.

CHAPTER THREE
SHARE CAPITAL REDUCTION

3.1. Introduction

It is a general principle of the common law that a company limited by shares could not dispose of funds subscribed as share capital by returning them to the shareholders. The basis of the rule against the return of capital is that since third parties do business with the company on the faith of its capital, that capital must not be reduced or returned except under statutory authority or court approval. This prohibition is thought necessary to protect creditors and perhaps shareholders and the public. However, due to certain commercial advantages which may necessitate a reduction of share capital and, which are believed would not cause any detriment to creditors or members of the company, the prohibition has been relaxed over the years by modern corporate statutes.

The relaxation of share capital reduction in modern corporate statutes are accompanied by safeguards assumed to be stronger than those under the common law. However, an evaluation of the methodology and mechanics of the reduction process under the current Australian law raises many policy issues and, leaves much scope for uncertainty. The aims and objectives of this chapter are similar to those outlined in Chapter 2 relating to buy-back.

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1 Every transaction between a company by any of its members, by means of which any of the money paid to the company by any of its members, in respect of a member's shares is returned to the member is a reduction of capital: see, Australasian Oil Exploration Ltd v Lachberg (1958) 101 CLR 119 at 132. A reduction of capital is also a step chosen by a company if it has sold off assets and wishes to return the proceeds to its members rather than reinvest the money in a new venture or, if it has suffered losses and wishes to write-off the capital representing the lost assets (see, Re Barrow Haematite Steel Co (1888) 39 Ch D 582; Bananlyre v Direct Spanish Telegraph Co (1886) 34 Ch D 287).

2 See generally, Trevor v Whitworth (1887) 12 App Cas 415; Re Exchange Banking Co (Flickroft's case.) (1882) 21 Ch D 519 there, the common law prohibition was based on the assumption that creditors 'are entitled to assume that no part of the capital which has been paid into the company's coffer is subsequently paid out, except in the legitimate course of its business'.

3 A number of statutes do specify that reduction may be for purposes of eliminating an earned surplus deficit or curing impairment due to losses or decrease in value of assets (see, Corporations Act 2001 (Cth), s 256; and Companies Act 1985 (UK), s 135). In practice, the corporations Act of most jurisdictions recognized that a reduction of capital may be sought for various reasons including: - a loss of capital during trading: Re Hoare & Co Ltd (1904) 2 Ch 208; - an excess of capital: Ex Parte Westburn Sugar Refineries Ltd. Some American authorities also show that a reduction can be used for the following reasons: - to 'un-dedicate' a sum of money from capital and, concurrently or subsequently, - to apply it for a variety of purposes: to distribute assets to shareholders (Dominguez Land Corp v Daugherty, 196 Cal 468 (1925)), - to remedy an existing deficit or capital impairment (Hamilton Mfg Co v United States, 214 F.2D 644 (7th Cir 1954)), - to write down or eliminate asset overvaluations.
3.1. Introduction

Accordingly, this chapter will show that it is not in all cases that a return of a company’s capital to its shareholders may erode the company’s capital base or adversely affect creditors and shareholders. It will further demonstrate that though creditors and shareholders may in certain circumstances be prejudiced by a return of capital, the maintenance of share capital doctrine, and the rule prohibiting companies from reducing their share capital fail to adequately provide the necessary protection. Moreover, the chapter has as its objective to illustrate that a loss reduction of capital which involves repayment to shareholders will be made better by a solvency requirement. It will be demonstrated that although some case law does not consider a reduction of capital to vary or abrogate class rights, there are circumstances when those rights could be affected yet, the maintenance of capital does not seem to effectively address the problem. It is argued that the special approval provisions under s 256C (2) suffer from lack of clarity.

It is further argued that while the Corporations Act seeks to address the problems that creditors and shareholders may encounter when a company reduces its share capital, it leaves much scope for uncertainty. This is apparent from the lack of an express indication of solvency, the lack of a ‘universal’ approach of determining the ‘fairness’ of a reduction of capital transaction and the difficulties in the special resolution provisions. Section 3.2 traces the history of the rule in Anglo-Australian jurisdictions. The legislative history in both Australia and the U.K demonstrates how both jurisdictions have evolved in their attempts of regulating transactions which concern the return of capital to shareholders, and how each took a different approach in subsequent years in reinforcing the protection needed by creditors and shareholders. Section 3.3 critiques the mechanics of share capital reduction by suggesting that clarifying legislation of the shareholder approval provisions may assist in making the law more user friendly. Section 3.4 evaluates the ‘creditor’ protection mechanisms and suggests alternative measures.
3.2. History of the Legislation

3.2.1. English History

The Companies Act 1862\(^4\) did not expressly prohibit a company from reducing its share capital. Accordingly, in Driwictch Patent Salt Co v Curson\(^5\), the court held that the power to reduce capital conferred on a company by its constituting body (a deed of settlement) could not be relied on once the company was registered as a company limited by shares. It was realized in due course that, there might be circumstances in which a reduction of capital would be expedient.\(^6\) A company, for example, may have reduced its activities either by wholly discontinuing some part of its operations or a subsidiary of it may have been taken over by another company. Therefore, it would be desirable to return to shareholders some of the paid-up capital for which it had no profitable use.\(^7\) As a result, the 1862 Act was amended by sections 9-20 of the Companies Act 1867\(^8\), permitting companies to reduce their share capital.

Sections 9-11 inclusive conferred a general power by stating:

Any company limited by shares may by special resolution, so far modify the conditions contained in its memorandum of association, if authorised to do so by its regulations, as originally framed or as altered by special resolution as to reduce its capital; but no such resolution for reducing the capital of any company shall come into operation until an order of the court is registered by the Registrar of Joint Stock Companies. Section 10, provided that a company that reduced its capital had to add the words “and reduced” after its name. In accordance with section 11, the company had to petition the court to sanction the reduction. The court also had a judicial discretion as to confirming a resolution for the reduction of the capital of the company, taking into consideration any objection by any creditor whose claims were not yet satisfied or secured. The confirmation ought not to be refused unless there is something ‘unjust or ‘inequitable’ in the reduction.\(^9\)

\(^4\) (25 & 26 Vict c 89). Section 12 only provided for an increase of capital if authorized by its articles but not for a reduction of capital.

\(^5\) [1867] LR 3 Ex 35. A reduction of capital was held to be inconsistent with shareholders having limited liability.

\(^6\) Refer to Hansard (1866) 65 col 234; Hansard (1867) 75 col 277 where arguments for lifting the prohibition were advanced.

\(^7\) Ibid.

\(^8\) (30 & 31 Vict c 131) came into force on the 1\(^{st}\) of September 1867.

\(^9\) By the 12\(^{th}\) and 13\(^{th}\) sections of the 1867 Act, where a company proposed to reduce its capital, and there were any creditors who were entitled to object or their consent was not attained or their claims were not secured, the court had to settle a list of creditors. Section 14 empowered the court to dispense with a list of creditors on security being given for their debts. In accordance with s 15, the minutes of the meeting and the court order were to be lodged with the Registrar of Companies, showing the amount of capital reduced, and the number & amount of each shares. The Registrar then issued a certificate as conclusive evidence of a reduction and a publication and advertisement was made. Sections 16-20 detail the liability for any breach of the Act. Members were liable to
The 1867 Act, laid down no special method of reduction. It was also narrowly interpreted to only authorise reductions of capital which involved capital being returned to shareholders but not, capital being written off or the liability to pay unpaid capital being extinguished. In 1877, Sir George Jessel commenting on the defects of the 1867 Act held in *Re Ebbw Vale Steel Iron & Co*\(^\text{10}\) that, the power to reduce the capital did not extend to cases where the capital had diminished through loss or depreciation. He said:

The object of the Act was to enable companies which had started with a larger nominal capital than they wanted and therefore had imposed on their shareholders a liability to pay a much larger sum in the share of calls than was required, or could fairly be required for the business of the company, to relieve the shareholders from a portion of that liability, and I think it had no other object.\(^\text{11}\)

The doubt expressed by Jessel MR was promptly solved by legislation. The result was the enactment of the *Companies Act 1877*\(^\text{12}\) which extended the general power conferred by the previous Act to unpaid capital and, also to make it possible for a company to write-off or cancel any lost capital.\(^\text{13}\) These changes aside, like its predecessor, the 1877 Act did not make special provisions on how the reduction of capital was to be effected. Consequently, the construction of s 3 proved to be problematic in certain respects. Two expressions, ‘capital unrepresented by available assets’ and ‘lost capital’ did not clarify

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\(^{10}\) (1877) 4 Ch D 827. Refer to *Hope v International Financial Society* (1876) 4 Ch D 327 where it was considered ultra-vires and void when a company attempted to reduce its capital contrary to legislation.

\(^{11}\) (1877) 4 Ch D 827 at 832.

\(^{12}\) (40 &41 Vict c 26), ss 3-11, came into force on the 23rd July 1877.

\(^{13}\) Ibid. Section 3 modified and elaborated on share capital reductions, providing that the word ‘capital’ as used in the 1867 Act (s 9), shall include nominal as well as paid up capital and that the power to reduce that capital shall include a power to cancel any lost capital, or any capital unrepresented by available assets, or to pay off any capital which may be in excess of the wants of the company and paid up capital may be reduced either with or without extinguishing, or, reducing the liability (if any) remaining on the shares of the company, and to the extent to which such liability is not extinguished or reduce, it shall be deemed to be preserved. ... In *Re Barrow Haematite Steel Co* (1888) 39 Ch D 582 for example, a company took the initiative to write-off its loss capital by reducing the amount of preference shares and paid up capital. In *Re Denver Hotel Co* (1893) 1 Ch 495, the court confirmed a reduction of capital which was considered in excess of the wants of the company. Section 4 modified s 15 of the previous Act which did not elaborate on publicity. Accordingly, s 4(2) is to effect that as the court thinks fit, it may require a company to publish reasons for a reduction or such other information in regards to the reduction with a view to give proper information to the public. As some authorities illustrate, s 4 appears to support the inference that capital may legitimately be reduced by buying out some of the members of the company—see, *British and American Trustees* [1894] AC 399; *Birch v Cropper & Re Bridgewater Navigation Co Ltd* (1889) 14 App Cas 525 at 543.
whether a ‘reserve’ forms part of the assets of the company that may be reduced. The courts had mixed opinions on this issue.

In *Re Direct Spanish Telegraph Co*, for example, Kay J sanctioned a reduction of capital where there was a reserve which it was proposed to retain. But, in the *Re Barrow Haematite Steel* case, Cozens-Hardy J opined that in ascertaining the available assets of a company for the purpose of a reduction of capital, the amount of a reserve fund must not be taken into account before a reduction is confirmed. Despite those drafting defects in the 1877 Act, it however remained in force until it was consolidated without change into section 40 of the *Companies (Consolidation) Act of 1908*. In 1926, the Greene Committee expressed some concerns about section 40 of the 1908 Act. The Greene Report recommended that the absence of a wide discretion in the court to dispense with a list of creditors under s 40 be reviewed and that the courts should be empowered under ‘special circumstances’ to dispense with a list of creditors even where there is a diminution of liability in respect of unpaid share capital or the payment to a share holder of paid up share capital.

Contrary to the decision arrived at in *Re Lamson Store Service Company* and *Re National Reversionary Investment Co Ltd*, where it was decided that the courts have no

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14 A ‘reserve’ or a ‘reserve fund’ for this purpose, is that part of the capital which represents premiums paid on preference shares.
15 (1886) 34 Ch D 317.
16 (8 Edw. 7 c 69), ss 39-46. Section 46(1) for the first time expressly authorized a company to reduce its share capital ‘in any way’ thereby defining an unlimited jurisdiction of the court to confirm any reduction of capital duly resolved upon by special resolution. (However, this power may have existed at an earlier date although not expressed in the Act. Lord Watson in 1894 in *British and American Trustee & Finance Co v Couper* (1894) AC 399 at 410 found reason to state that: “I do not find a single expression in the Act tending to indicate that the discretion of the court to grant or refuse such an application does not extend to every possible mode of reducing capital.”
18 Ibid, paras 20-21. It is noteworthy that the issue of whether a court could dispense with settling a list of creditors had existed since 1867 but no problem came up whether the courts could dispense with such a list. Also see the cases of *Re Lamson Store Services Co* [1895] 2 Ch 726 at 729; *Re National Reversionary Investment Co Ltd* [1895] 2 Ch 726 at 729.
powers to dispense with the settling of a list of creditors as required by s 13 of the
Companies Act 1867, the Greene Committee’s recommendation was adopted and inserted
as ss 50-60 of the Companies Act 1929, which contained capital reduction provisions
empowering the courts to dispense with a list of creditors.\(^{21}\)

Section 55(1) of the 1929 Act restated section 3 of the 1877 Companies Act in similar
terms. Section 56(3) introduced the solvency requirement which was intended for the
protection of creditors. The rest of the capital reduction provisions in the Act of 1929
remained unchanged from previous Acts. It is, however, noteworthy that the power
enshrined in the Companies Acts 1867-1929, allowing companies to use their share
premium account for any purpose including the writing-off of losses and goodwill was
arguably, too broad and vague. The capital reduction provisions in the 1929 Act were
amended by sections 66-77 of the Companies Act 1948.\(^{22}\) Those sections made it clear
that a company could not reduce its share premium account or capital redemption reserve
fund as had existed since 1877.

In Scottish Insurance v Wilson & Clyde Coal Co.\(^{23}\) the courts recognised that in a
reduction of capital, or any scheme for the reduction of capital, a certain class of
shareholders (especially minority and preference) shareholders may be prejudiced. In this
respect, they formulated the “Spens Formula”. This formula recognised that a reduction
of capital may be unfair to a class, although it treats that class in strict accordance with its

\(^{20}\) [1895] 2 Ch 726 at 729. The Re Lanson Store Case and the Re National Reversionary case were decided at the
same time.

\(^{21}\) (19 &20 Geo c 23) came into force in 1929.

\(^{22}\) (11 & 12 Geo 6 c 38), s 66(1) did not expressly prohibit the reduction of capital. However, it was held that the
terms permitting a reduction impliedly prohibited a limited company from reducing its share capital except as
expressly permitted by the Act. Sections 67-68 restated the already established ‘creditor test.’ The section also
required creditors consented to a reduction or that their debts were satisfied or secured before a reduction of
capital was confirmed. The advertisement test(s 68(2)) was in effect that the company publish reasons for the
reduction of capital and, as the court thinks fit, the causes which led to the reduction. The court would not make
an order confirming a reduction of capital where there was no advertisement of the reasons for such a reduction
with the Registrar of Companies. Under the advertisement test, the court had regards to the effect of the reduction
on the interests of creditors. They would normally require the reduction be advertised so that creditors could come
forward and object (i.e., the advertisement of the application to confirm the reduction is intended to give
creditors, amongst others, notice of the proceedings and the opportunity to seek to object to the proposal although
they may not be greatly affected. The hearing of the application for reduction should be advertised with the rules of
court. Adequate disclosure of material information was also an important consideration in an application for
confirmation.

rights. With this formula, preference shareholders are given effective voting rights in a separate class meeting. The scope of the formula is limited only to publicly listed companies, meaning the protection is not available to private companies and to those preference shareholders whose shares are not quoted.24 Generally, when s 66 is viewed in terms with s 72 concerning variation of class rights, a question may be posed as to whether in a reduction of capital, a company needs to also have recourse to class rights procedures.25

In 1962, the Jenkins Committee26 recommended that ss 68(2) & (3) of the 1948 Act27 be repealed on the grounds that they served no useful purpose.28 The Committee further recommended that s 66(1) be clarified so that a limited company be expressly prohibited from reducing its capital otherwise than by statute. Moreover, with precedents drawn from the Scottish Insurance Corp v Wilson & Clyde Case,29 they recommended that to adequately protect the interests of all creditors and shareholders, the court should obtain an independent assessment of a reduction of capital scheme.30

24 In comparison, the 'Spens formula' is not commonly used in Australia, as regards the fair treatment of shareholders. However, the procedure applied in Australian law by both the legislature and the judiciary under the fair and reasonable test achieves the same purpose as the Spens formula (the test requires that where shares of a company consists of different classes of shares, the application of a 'fair & equitable' or 'fair & reasonable' test would require the court to consider the fairness of the proposed reduction as between the classes). Thus, as in Re Fowlers Vacola Manufacturing Co Ltd [1966] VR 97, an equivalent of the 'Spens formula' (the 'fair & reasonable' test) was used as a factor for safeguarding the interest of preference shareholders and other members of the company as a whole.

25 The courts have traditionally suggested that a reduction of capital does not of itself, affect or vary class rights: Re Solidold Estate Co Ltd [1968] 1 WLR 1844. However, this proposition remains questionable. Compare Re Old Silkstone Collieries Ltd (1954) 1 All ER 68. For a detailed discussion of the questionable approach between a reduction of capital and variation of rights procedures, see subpart 3.3.4.1 (below at 127). It is further noteworthy that s 66 fails to specify the manner in which a reduction shall take place. However though it casts its net wide open and leaves a company to determine the extent, the mode and the incidence of a reduction, there are nevertheless certain governing principles concerning the manner in which share capital may be reduced. Refer to, Bannatyne, above n 1; Re Barrow Hemiattite Steel Co (1888) 39 Ch D 582 (for some examples of the prima facie rules for the reduction of share capital).


27 Companies Act 1948, s 68(2) contained provisions for a company to publicise and advertise the reasons for a reduction. Section 68(3), required a company after a reduction process to add the words "and reduced" after its name.


29 (1949) AC 512.

30 Jenkins Committee Report (1962), paras 157-160. Although some members of the Committee were of the opinion that the 1948 Act be amended by removal of the 'consent provision' available to preference shareholders, (on the reasoning that such consent is no longer necessary because of the safeguards introduced by the Spens formula). The committee did not see the need for the law to be altered on the argument based on the spen-formula. It recommended that the law should be maintained and that preference shareholders' consent should continue to apply.
In 1976, the Second Company Law Directive\textsuperscript{31} in art 32, stated that the capital yardstick represented by issued share capital plus share premium account and capital redemption reserve should not be reduced except under an order of the court.\textsuperscript{32} Most of the Jenkins Committee recommendations and the 2\textsuperscript{nd} Directive were adopted and reinforced by the Companies Acts 1980/1981.\textsuperscript{33} Private companies were allowed to reduce their capital without obtaining court approval\textsuperscript{34} although the safeguards which surrounded this grant of power were made more stringent.\textsuperscript{35} The reduction of capital provisions in the Companies Act of 1981 later became sections 135-142 of the Companies Act 1985.\textsuperscript{36}

However, some slight changes were made by ss 381A and 113 of the Companies Act of 1989, requiring both public and private companies to reduce their share capital in accordance with a special resolution of the company and, for the directors to be required


\textsuperscript{32} Ibid, arts 32-34. By its art 34, the 2\textsuperscript{nd} Directive, stated that the subscribed capital may not be reduced to an amount less than the minimum capital laid down in accordance with art 6.

\textsuperscript{33} Companies Act 1981, ss 53-57.

\textsuperscript{34} Ibid. s 53. As already seen Chapter 2 on Buy-back rule in subsequent chapters, ss 171-177 of the repurchase provisions of the 1985 Companies Act, private companies are required to acquire their own shares 'out of capital' without the need of a formal reduction of capital procedures. By this process therefore, it can be argued that the reduction of capital procedures can be easily weakened since they could easily be sidestepped by private companies.

\textsuperscript{35} Companies Act 1981, s 54 for example, limits the amount by which capital may be reduced and controls adjustments to the company's accounts. Furthermore, the legislation requires the directors to make a statutory declaration of solvency under s 55(3) (a) to the effect that the company would be able to pay its debts as they fall due. This section is reinforced by s 55 (5) to the effect that such solvency declaration must be accompanied by an 'expert' (auditor's) report. Although the power of private companies is circumscribed with disclosure and solvency requirements, arguably, and from a comparative point of view, when recourse is had to the Canadian and American styled repurchase provisions, the recommendations by the Jenkins Committee (paras 167-169) and the 2\textsuperscript{nd} EC Directives, arts 19-22 exempting private companies from general procedural requirements may be questionable.

\textsuperscript{36} Companies Act 1985, Chapter IV of Pt V Table A, art 34. Though a return of capital clearly involves a transfer if assets, however, depending on the type of reduction, where no transfer is involved creditors do not have any right to object in a proposed reduction. The court is also concerned to ensure that creditors' interests are protected under ss 136-7 by the company for example, providing the court with evidence of a bank guarantee for instance, for all existing debts. Section 136 provides an elaborate requirement whereby creditors must be informed of the proposed reduction and either consent to it or be paid off. This can only be waived by the court under the 'special circumstances' clauses which demonstrates creditors have been satisfied. The judiciary retains its tradition that a reduction of capital does not affects the variations of rights provisions set out in s 125 of the 1985 Act, mindful of other judicial dicta to the contrary: (refer to House of Fraser plc v AGOE Investments Ltd [1987] AC 387 and compare it with Re Northern Engineering Industries plc [1993] BCLC 1151). The 1985 Act remains the principal Act although slightly amended in 1989 by the Companies Amendment Act of 1989. The principal Act has further been complimented by ss 5 & 6 of the Insolvency Act 2000 and the Directors' Disqualification Act of 1986 whereby, directors may be disqualified as directors in breach of the solvency and disclosure requirements. However, the ambit of these sanctions and liability has been open to criticism.
to make a formal declaration of solvency pursuant to any purported reduction scheme. Creditors were also given the opportunity to challenge a reduction in court. Section 142 required directors of a public company which lost half or more of its paid-up share capital to call an extra-ordinary general meeting within 28 days to consider what steps to take to address the situation.\textsuperscript{37} The Company Law Steering Committee\textsuperscript{38} recommended that companies be no longer required to seek court approval for a reduction of share capital, and that the section prescribing that a solvency declaration be followed by an auditors report be repealed.\textsuperscript{39}

3.2.2. **Australian Legislative History**

Prior to 1890, the Australian colonial companies legislation was modeled from the English \textit{Companies Act of 1862}\textsuperscript{40}. However, influenced by the legislative changes made by the 1867 Act\textsuperscript{41} together with some English authorities,\textsuperscript{42} the State of Victoria took the initiative in passing the \textit{Companies Act of 1890}\textsuperscript{43} allowing companies the power to reduce their share capital. The 1890 Act did no more than restate the general provisions and principles already well established by sections 9-20 of the English legislation. However, like its predecessor the 1867 Act (UK), the 1890 Act did not define the word ‘capital’, neither did it made provisions for companies to write-off any lost capital.\textsuperscript{44}

\textsuperscript{37} This requirement is in accordance with the 2\textsuperscript{nd} EU Directive, above n 31, article 17.
\textsuperscript{38} Great Britain, Department of Trade (“DTI”) – The Company Law Steering Committee, \textit{Company Formation and Capital Maintenance: Company Law Compelling the Structure} [June 2000].
\textsuperscript{39} Ibid, paras 7.8, 7.10 at 151. These proposals were however withdrawn after staunch opposition from members of the Committee. DTI however accepted the view that the present court procedure be retained but further recommended that a solvency statement should not be supported by an auditors report. These recommendations though enacted under the 1989 Companies Act, have yet to be completely applied.
\textsuperscript{40} Before and even after Australian legislation allowed limited companies to reduce their share capital, there have been much debate in parliament on this issue. (Refer to Hansard, Victoria Parliamentary Debate (VPD) (1893) at 71-73). Mr Turner, one of the members in parliament for example, had argued that it would be unfair to allow companies reduce the capital that creditors and the public relied on for their debts.
\textsuperscript{41} See, \textit{Companies Act 1867} (UK), ss 9-20.
\textsuperscript{42} See for example, the cases of Re Munz Metal Co (1870) 18 WR 1064; Re Credit Foncier of England Ltd (1871) LR 11 Eq 356.
\textsuperscript{43} \textit{Companies Act 1890} (Vic) (54 Vict. No 1074), ss 2, 8 & 52, came into force on the 1\textsuperscript{st} August 1890.
\textsuperscript{44} This meant that loss reductions were still prohibited. Comparatively, the \textit{Companies Act 1892} (South Australia), in its s 68, was the first State Jurisdiction to have addressed the issue raised above in similar terms with s 3 of the \textit{Companies Act 1877} (UK). Presumably therefore, while Victoria took the first initiative in allowing companies to reduce their capital, in practical terms, it was the 1892 Companies Act (SA) that first elaborated and fully addressed the rule. Some commentators in the House of Parliament even put it that, the 1890 Act was poorly drafted and passed in a haste and panic -see for example; Messrs Vale & Carter, \textit{Companies Act Amendment Bill 1890}, VPD (1892-93)72-73.
Chapter 3 3.2 Legislative History (Australia)

As a result, therefore, of the English authority in *Re Ebbw Vale Steel Iron & Co*\(^4\), and the 1877 Companies Act (UK), the 1890 Act (Vic) was amended and consolidated under the *Companies Act 1896 (Vic)*\(^5\) to enable any company that had lost a part of its capital to write-off the loss from the capital account without reducing the liability remaining on the shares of the company. Section 98 of the 1896 Act (Vic) also fell short of defining the term capital as used in the Act but, merely enlarged the meaning of the word in section 88 to include paid-up capital. In *Re Ballarat Land Mortgage & Agency Co.*\(^6\) the language and interpretation of sections 89, 90 and 94 of the *Companies Act 1896 (Vic)* was considered problematic.\(^7\)

Australian courts had divergent opinions concerning English authority\(^8\) which supported the view that the courts could not dispense with the settlement of a lists of creditors.\(^9\) Influenced partly by the drafting defects in sections 89, 90 and 94, and the decision in *Re Ballarat*, the 1896 Act (Vic) was amended and consolidated in the *Companies Act of 1915*.\(^10\) In *Re Mortgage Bank*\(^11\), it was decided that to give the court the jurisdiction to entertain a petition for a reduction, it was not essential that the paid up capital which the company proposed to write-off was lost or unrepresented by available assets.\(^12\) Sections 56 & 57 were inserted to amend sections 89, 90 and 94 of the 1896 Act.

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\(^4\) (1877) 4 Ch D 827

\(^5\) (No 1482) ss 87-101. Similarly situated were the *Companies Acts 1899 (NSW)* ss 39-42 and the *Companies Act 1892 (SA)* ss 65-73.

\(^6\) [1897] 3 ALR 216.

\(^7\) Sections 89, 90 and 94 were similarly worded with section 13 of the *Companies Act 1867 (UK)*, requiring the courts to take into consideration the consents of creditors, ensuring that their debts have either been settled or secured and that a list of creditors be settled to that effect.

\(^8\) Refer to *Re Lamson Store Services Co. & Re National Reversionary Investment* [1895] 2 Ch 726 at 729; See also section 13 of the *Companies Act 1867 (UK)*.

\(^9\) In *Re Ballarat*, above n 47, Holroyd J in interpreting ss 89, 90 & 94, drew support from s 13 of the 1867 Act (UK) and from the *Re Lamson* case (ibid) and opined that, as ss 89, 90 & 94; originated from the English authorities where the issue was well documented, our courts cannot detract from such precedents. Generally, the Australian courts have used their discretion in most cases to dispense with a list of creditors, a practice which the English authorities have opposed.

\(^10\) (1915) 6 Geo V. No 2631) ss 53-62, came into operation on the 1st October, 1915.

\(^11\) (1916) 13 ALR (CN) 27.

\(^12\) This view may be argued, seems inconsistent with the English Legislation (ss 3 &9 of 1877 Act) and, case law such as *Re Ebbw Vale Steel Iron & Co* (1877) 4 Ch 827. It may be that since the Anglo-Australian jurisdictions did not legislate on a minimum capital requirement, it was therefore not necessary that paid up capital be lost. (See the case of *Re Mortgage* (ibid) to ascertain the reasons for the inconsistent view). It will later be seen that under s 258F of the current law *(Corporations Act)*, a company may reduce its share capital by cancelling any paid-up share capital that is lost or is not represented by available assets. This power, however, does not apply if the company also cancels shares. But, it should also be taken note of that the Australian position seems to be consistent with some English cases. Thus, since *Poole v National Bank of China* [1907] AC 229, it was accepted that a company is not restricted in reducing its capital in circumstances in which capital has been lost or is unrepresented by available assets or, is in excess of the needs of the company. (This view as will be seen later, was inserted in s 123(1) of the 1981 Company’s Code).
In *Re Squatting Investment*\(^54\), it was decided that in any reduction of capital, it was a condition precedent for the courts to settle a list of creditors—but, since an unlimited jurisdiction was vested to the courts at common law, it was perhaps left to the courts to decide whether to apply the English position or the Australian position (that is, allowing the courts to dispense with a list of creditors).

It is not clear what prompted the 1915 *Companies Act* (Vic) to be amended. However, the problem as to whether the courts could dispense with a list of creditors continued to trouble the courts and the legislatures. As the English authorities and statutes continued to play a vital role in influencing the shape of the legislation, the consequence was that the 1915 Act was amended by the *Companies Act 1938* (Vic)\(^55\) and further amended by the *Companies Act 1958* (Vic).\(^56\) In accordance with the decision in *Re Cadzow Coal Co*\(^57\), and modeled from s 56(3) of the 1929 English Companies Act, section 57 of the *Companies Act 1938-1958* (Vic), required companies to show that in any proposed reduction of capital scheme, they were solvent and would remain solvent.

A comparatively recent innovation was introduced by section 58(2) of the *Companies Act 1938-58* (Vic)\(^58\) as a result of the decision in *Re Cotton, Palmer & Preston Ltd*.\(^59\) This case, together with section 58(2), were to put an end to the question that had troubled the judiciary for quite some time—i.e., the issue of whether or not the courts should dispense with a list of creditors. Section 58(2) provided that in a reduction process, ‘the courts may, if having regard to any ‘special circumstances’ of the case, direct that section 58(1) concerning the settlement of a lists of creditors, shall not apply to

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\(^{54}\) (1916)5 ALR (CN) 89  
\(^{55}\) (No 4602) came into force on the 31\(^{st}\) of March 1939. Provisions relating to reduction of capital fall within ss 55-61.  
\(^{56}\) (No 6455) Assented to on the 2\(^{nd}\) December 1958. The provision governing reduction of capital is within s53 (1-9). For purposes of convenience, they shall be jointly referred to as the *Companies Act (1938-58)* (Vic).  
\(^{57}\) [1931] SC 272 (Crt of Session-Scotland)  
\(^{58}\) Similarly, see s 76(2) of the *Companies Act 1934-60* (SA).  
\(^{59}\) [1936] SASR 434.
any class or classes of creditors. By implication, therefore, section 58(2) had in effect legislated that the courts may under these ‘special circumstances,’ dispense with the settlement of a list of creditors. The provision did not define nor give guidelines as to what constitutes a special circumstance. The guidelines given in the Re Cotton Palmer case, it may be argued, do not adequately protect creditors’ interests.

In the process of attempting to unify the company law in the Commonwealth of Australia, coupled with some of the already examined defects in the company statutes in State Jurisdictions, the provisions of the previous Acts were amended and consolidated to form the Uniform Companies Act 1961/62. Section 64 reflected the already established principles and procedures in previous Acts. However, in Re Galpin, Ex Parte Chovilla Timber Supply Co Ltd—a debate was triggered about the construction of s 64. This was related to the issue of the priority position of shareholders in a reduction process concerning the variation of class rights and the distribution of excess capital in a winding

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60 Companies Act 1938-58 (Vic), s 58(2) states: “Where a proposed reduction of share capital involves either the diminution of any liability in respect of unpaid share capital or the payment to any shareholder of any paid up share capital, the court may, if having regard to any special circumstances of the case it thinks proper to do, direct that the last preceding sub-section shall not apply as regards any class or any classes of creditors.” It should also be taken note of that while s 48 of the 1938 Companies Act did not expressly say whether a share premium account were paid up share capital, as a result of that gap, that section was amended by s 50 of the 1958 Act, by the addition of the stipulation that the reduction of capital provisions apply ‘as if the share premium account were paid-up share capital of the company’.

61 Some of the guidelines indicated in the Re Palmer Cotton case are for example that: the courts should be satisfied that the company’s assets would exceed its liabilities or that, a bank guarantees creditors’ debts. While the bank guarantee may look commendable, some authorities have illustrated that a surplus of assets over liabilities does not constitute a satisfactory guide of what is to be regarded as a special circumstance (Refer to Re F de Jong & Co [1946] 1 Ch 211 where it was decided that, situations where a company’s assets exceed its liabilities can not be considered ‘special circumstances’ in the context that such circumstances have failed to protect the interests of creditors. Refer also to the Re Palmer Cotton case where Cleland J put it that, it would have been more appropriate for the courts to disregard s 58(2) and in its stead, rather consider that no creditors, actual disputed or even unascertained, will be prejudiced by the omission to settle a list of creditors.

62 Uniform Companies Act (“UCA”) 1961/62 (No 71), s 64 was Amended to 27th December 1961 and commenced on the 1st of July 1962.

63 (1967) 11 FLR 155 (Fed Crt of B’klyn). The issue in question was whether in a reduction of capital where a company has an excess capital, should it be addressed by contractual agreements between the parties or by the terms in the company’s constitution? However, by implication, in ss 64 and 65 and the cases interpreting those sections, there is a proposition of law that in reducing share capital, companies need not comply with class rights and that, the courts need not have much consideration of those rights. (Note that the terms of issue of shares may deem a reduction to be a variation of class rights). Both the English and Australian courts have overruled any decision by minority shareholders to invoke the variation of rights provisions in connection with a reduction of capital (Re Salideon Estate Co Ltd 1968) WLR 1844; Re Fowler Vascola Mfg Co Ltd 1966) VR 97. For an elaborate analysis of this issue, see subpart 3.3.4.1 below, where reduction of capital and variation of rights are discussed. For some relevant literature on this legal issue, see, J.H. Telfer and R.J Mitchell, “Reductions of Capital and the Rights of Minority Classes of Shareholders: A New Approach to Section 64” (1981) 55 ALJ 251; S. Lindsay, “The Position of Preference Shareholders in a Reduction of Capital” (1987-88) 5-6 C&SL J 77; Wedderburn, “Shareholders’ Rights and the Rule in Foss v Harbottle” [1957] CLJ 194. Mason, “Ratification of the Directors’ Acts: An Anglo-Australian Comparison” (1978) 41 MLR 147.)
up. While section 64 is silent on the issue, case law is to the effect that preference shareholders are given priority position and a loss should normally first be applied to ordinary share capital. The 1961 Act was replaced unchanged by a modified provision, section 123 of the Companies Code 1981. Ringston & Anor v Repose Pty Ltd (No 2), exposed certain defects of s 123, in terms of valuation of the company’s assets to be paid to one group of members. It was unclear as the above case shows, whether in valuing the company’s assets consideration should be focused only on section 123 which confined its application to ‘market value’ (market price). An appropriate benchmark against which to measure the fairness of a capital reduction canceling shares is the market value although, the courts have generally neglected to explore the fairness of a proposed reduction by reference to its market value. It was considered as a legislative consideration in Caruth v Imperial Chemical Industries.

However, the difficulties of determining the fairness of a proposed reduction of capital under s123 prompted the National Companies and Securities Commission (NCSC) to

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64 This proposition as illustrated in the Matters of Fowlers Vacola Mfg Co Ltd [1966] VR 97 and Re Chatterley-Whitfield Collieries Ltd [1948] WN 367. Section 33 of the 1948 Company Act (UK) for example, seemed to have legislated that, the articles of association reign supreme and as such, preference shareholders have a priority position and were to participate in the division of the company’s surplus capital pari-passu with ordinary shareholders. There is also a rebuttable rule that, prima facie, a reduction which is consistent with the rights of classes of shareholders in a winding up will be considered to be fair and reasonable. Therefore, a loss must be borne first by ordinary shareholders. This consistency is illustrated in: British and American Trustees [1894] AC 399; Scottish Insurance Co v Wilson & Clyde Coal Company [1949] AC 462 HL.

65 Companies Code 1981 (hereinafter as the ‘Code’), s 123 as read together with ss 11, 15, 42 & 43(6) of the Companies Acquisition of Shares Code (CASC) were passed by parliament to address some of the problems associated with s 64.

66 (1988) 6 ALC 111. Similarly, in the case of Catto v Ampol (1989) 7 ALC 717, at 720, Rogers AJA and Priestley JA, argued that s 123 was flawed and defective in the sense that the courts could not determine that a reduction scheme was fair and equal only by relying on the market value as postulated by s 123, without regards to asset backing and other wider range of circumstances. It is noteworthy that the very generality of the criteria involved in the application of s 123 imported into its language by judicial decisions, presents a question on interpretation in which minds differ. See also Re Holdings Investment Trust Ltd [1971] 2 All ER at 291 which similarly interprets the difficulty of s 123.


68 [1937] AC 707. Market value was also considered in Re William Jones & Sons Ltd [1969] 1 WLR 146 there, the return at par value was considered fair because although preference shareholders were losing substantial rights to share in a winding-up, they received more than the market value of their shares. It is to be recognised that accountants and financial analysts view to market value may not be too consistent with market value from a legal point of view, though in most cases, the law derives guidance from those areas. For a detailed consideration on whether a transaction affecting share capital affords an adequate degree of ‘fairness’ to corporations, (especially viewed from the context of ‘fair & reasonableness’; ‘fair & equitable’; fair or market value’) see subs 3.4.2.2, below at 154.
participate in cases involving important questions of company law and to assist the courts in determining the application of the ‘fairness & equitable’ principle. Furthermore, in determining whether s 123 applied for purposes of a gratuitous disposition, guidance was obtained from the New Zealand decision in Jenkins v Harbour View Court Ltd, and also from Catto v Ampol.

There, the issue was whether in a gratuitous disposition involving a reduction of capital, the adequacy of the consideration should be a determining test or, whether, the consideration should be the impact of the reduction on the value of the company’s undertaking. The courts opined that either of the two approaches may provide the basis for determination. As a consequence, therefore, section 123 was amended by ss 195 (13) &(14) of the Corporations Law.

An innovation was introduced by s 195(7) as a result of the Companies Acquisition of Share Code and the decision in Re Campaign Holdings to give the ASC power to intervene in matters considered unfair and inequitable to certain class of shareholders.

The effect of which was that, henceforth, the minutes of the special and general resolution and the courts order have to be now lodged with the Australian Securities Commission.

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69 Refer to North Sydney Brick & Tile Co Ltd v Darwall Ltd and Anor (1986) 4 ALC 539 at 541; Hamilton v Oades (1989) 7 ALC 381. (The ‘NCSC’ intervene in the court decision in determining the fairness of a proposed reduction process).


71 (1989) ALC 717

72 Corporations Law 1989 (CL) (Cth), (No 109), Sch I Table A reg 39; Sch I Table B, reg 23; Div 4B of Pt 2.4, s 195. Assented on 14th July 1989 became effective on the 1st of January 1991. The general requirements for accomplishing a capital reduction under s 195 were thus: (1) the company’s articles of association (later known as the ‘constitution’) authorised the reduction of issued capital, (2) the shareholders in a general meeting had to approve the reduction of issued capital by a special resolution, (3) the Court had to approve the special resolution to reduce the capital based on creditor approval (By this, subs. 195(3) provides for procedures designed to ensure that creditors of the company who could be prejudiced by a reduction proposal, are apprised of it and given an opportunity to object to this, and, that their positions are protected. (4) After confirmation by the court, a copy of the resolution had to be lodge with the Australian Security Commission (ASC) to be later known as (Australian Securities Investment Commission-(ASIC)) (See, also ASC Release, ‘PN’ 29 (1993) para 10. Although s 195(1) exemplifies some of the modes and circumstances in which a company’s capital may be reduced, the capital of the company can be reduced in any way notwithstanding s 195(1) which include-extinguishing or reducing the liability on any of its shares which are not fully paid up; canceling any share that is lost or not represented by available assets and paying off any paid up capital which is in excess of the needs of the company. (These are easily illustrated in cases such as: Poole v National Bank of China Ltd [1907] AC 229; Nicon Resources Ltd v Catto (1992) 8 ACSR 219; Re Rancoe Ltd (1995) 17 ACSR 206).

73 (1990) 8 ACSR 64. The case evidence that in any reduction scheme, there must be adequate disclosure and the members must be treated fairly. On the disclosure requirement, it should be shown that the company should disclose necessary to enable shareholders to make an informed decision on how to vote. The company is also compelled to disclose what is actually proposed to be done and all material reasons for the proposal.

74 ASC ‘PN’ 29 recommends that those shareholders receiving consideration from the selective reduction should abstain from voting at a general meeting of shareholders. (Refer generally to ASC Released Practice Note 29 entitled “Selective Capital Reduction” (July 20th 1993) 1 ASC Digest PN 2/12 paras 17, 27-29). ASC also indicated that it could exercise its powers under s 1330 to intervene in the courts confirmation proceedings if it
Chapter 3

3.2 Legislative History (Australia)

While s 195 sought to attain one of the objectives of the capital maintenance doctrine (i.e., protection of creditors due to the creditor consultative process in its requirements), the section was couched with difficulties in application. Firstly, it was difficult to reconcile s 195 with s 192. Section 195, for example, considers the redemption of preference shares to be a reduction of capital which was prohibited by law unless sanctioned by the court. But, under s 192, a redemption of share capital is not considered a reduction of capital and a company may redeem such capital without the necessity of a court sanction. Secondly, s 195 further seemed to be inconsistent with the reduction decision making process especially if s 195(1) is read together with s195(7) and articles 39 and 66(1) of the Corporations Law.\textsuperscript{75}

In 1995, the Corporations Law Simplification Task Force recognised that s 195 was flawed and not an effective control on the reduction of share capital.\textsuperscript{76} They proposed that s195 be repealed. They further recommended that court approval be abandoned and

\textsuperscript{75} regarded a proposed selective reduction as potentially unfair to minority shareholders. Under s 195 therefore, ASC and the courts developed principles to protect minority shareholders under a selective capital reduction. In assessing the fairness of a proposal for selective reduction, ASC identified two important factors for consideration namely: (i) the form and content of any expert report; and (ii) the voting procedures for the resolution to reduce share capital (ASC PN29, paras 34-42). The requirement for an expert report is to express an opinion as to whether the proposed reduction is 'fair and reasonable' to those shareholders whose shares will be cancelled. It thus strikes a balance between the shareholders leaving and those remaining with the company (see, for example, Ramsay Health Care v Elkington (1992) 7 ACSR 73; Re Hudson Conway Ltd [1993] 12 ACSR 668. The process of court confirmation and s 195 generally, is to ensure both creditors (present and future) and shareholders are protected.(see, e.g., Re Credit Assurance & Guarantee Corp Ltd [1902] 2 Ch 601(protecting interests of creditors); Re Robert Stephens Holdings Ltd [1968] 1 WLR 522 (interests of members protected).

As indicated in: Ramsay Health Care Ltd v Elkington (1992) 7 ACSR 73, it is questionable whether s 195 permits a past event to be or be deemed to be undone. Moreover, the case of Re Hunters Resources Ltd (1992) 34 FCR 418 portrays that it is often unclear the precise point at which s 195 ceases its work and an associated scheme of arrangement takes over. Another difficulty envisaged by s 195 is the soundness of the courts approval method which some have argued is too procedural and costly to implement (Refer to the Company Law Simplification Program; Share capital Rules Proposals for Simplification, (Nov 1994) para 10 which proposed for the repeal of s 195).

\textsuperscript{76} Company Law Simplification Program (Ibid) submitted that the proposals to replace s 195 is one which reflects the commercial reality that creditors seek protection through other means, that s 195 was seen as an extra cost and unnecessary complication to a legitimate commercial practice, and that s 195 largely neglects the interests of minority shareholders. However, these proposals omit the provisions dealing with creditor consultation, and replaces these with the straightforward requirements to notify ASC (ASIC) and seek to ensure that a company maintains its assets greater than its liabilities. The proposals also recommend that the requirement for authorization in the company’s articles be abolished since the articles could simply be changed by special resolutions at the same meeting which considered the reduction, making this requirement ineffective. (Refer also to, Simplification Task Force, Corporations Law Simplification Program- Second Corporations Law Simplification Bill, Exposure Draft, Volume 2 Provision (June 1995) at 105-106.
that both equal and selective capital reduction should require shareholder approval.\textsuperscript{77} Although these reform proposals were not immediately acted upon, when the Corporate Law Economic Reform Program (CLERP) replaced the Task Force in March 1997, the reform agenda initiated by the Task Force was continued.\textsuperscript{78} The consequence of which was the adoption of all of the recommendations by the \textit{Company Law Review Act 1998}\textsuperscript{79} and inserted as sections 256A-256E later, consolidated into the \textit{Corporations Act 2001}.\textsuperscript{80}

3.3. \textit{The Mechanics of the current Reduction of Capital Regime.}

3.3.1. \textbf{General Procedures.}

Sections 256A-256E provide the general procedures for a reduction of capital.\textsuperscript{80} They reflect a fundamental shift in philosophy not only on the share capital reduction rule but on the whole tenor of the capital maintenance regime. Section 256A states the purpose of the new legislation.\textsuperscript{81} Section 256B contains the cardinal provision. It states that a company may now reduce its share capital without requiring court approval\textsuperscript{82} or,

\textsuperscript{77} The Corporations Law Simplification Program: \textit{Share Capital Rules, Proposals for Simplification} (Nov 1994) para 10. See also, Corporations Law Simplification Task Force: Plan of Action (December, 1993). In their terms of reference and proposals, there was no reference for creditors to be consulted or informed of any proposed capital reduction. However, despite the inference of creditor involvement in the Task Force Proposal, disclosure obligations and courts remedies will also be impaired to allow shareholders and creditors to intervene in the cases where their interests may be unduly prejudiced. Also, they proposed that the ASC be notified within 14 days before the reduction so as to be able to make the information available to those who conduct a search, through the ASC ‘Alert System’.

\textsuperscript{78} The Explanatory Memorandum to the Company Law Reform Bill explained the reasons why it was necessary to repeal the provisions on court sanction thus: “It is not appropriate for every capital reduction to be subjected to the time and expense of court confirmation, particularly as the safeguards that this brings can be provided in different ways.” The thrust of the 1998 reform as Ford et al., puts it, is to remove the time and expense of routine court confirmation while ensuring that there are safeguards for creditors and members which are equally effective ((Ford et al. \textit{Ford’s Principles of Corporations Law} (Sydney: Butterworths:2003) para 24.520).)

\textsuperscript{79} \textit{Company Law Review Act 1998} (Cth), came into force on the 1\textsuperscript{st} of July 1998.

\textsuperscript{80} Sections 258A-F which operate completely independently of s 256, deal with some of the other situations in which reductions of share capital are authorized. Under s 258A-F inclusive, companies are expressly authorized to reduce their issue capital by redeeming redeemable preference shares out of the proceeds of a new issue of shares made for the purpose of the redemption (s 258E(1)(a) by canceling shares returned. According to s 258E (2), a company may cancel shares returned to it under ss 651C, 724(2), 737 or 738 and any reduction in the company’s share capital that is involved is authorized by this subsection.

\textsuperscript{81} Section 256A provides that the rules are designed to protect the interests of shareholders and creditors by: (a) addressing the risk of these transactions (reductions in share capital and share buy-backs) leading to the company’s insolvency; (b) seeking to ensure fairness between the company’s shareholders; (c) requiring the company to disclose all material information.

\textsuperscript{82} Although court power is ‘no longer a requirement’, the legislation recognises that a court order may be sought under s 1324A and 285E (3). By s 1324, members whose interests may be shaken by any purported agreement or scheme, may invoke the section by applying to the court for an injunction relief restraining a contravention of s 256B. (See, the NSW Court of Appeal decision in \textit{Wispar Holdings Ltd v Goldfield Kalgoorlie Ltd} [2001] NSWCA 427 for the cut-off time for seeking relief). Moreover, notwithstanding the fact that authorisation is not needed by the company’s constitution, the Act indicates that a constitution may include a provision that imposes restrictions on the company’s ability to reduce its share capital. The effects of such restriction as found in s 125
constitutional authorization. Section 256B(1) prescribes the new principles and requirements in a different style from those of the repealed Acts.\textsuperscript{83} The section empowers companies to reduce their capital in a way that is not otherwise authorised by law, if the reduction:

(a) is ‘fair and reasonable’ to the company’s shareholders as a whole;
(b) does not ‘materially prejudice’ the company’s ability to pay its creditors; and
(c) is approved by a majority of shareholders under section 256C.

While the phrase “company’s shareholders as a whole” under s 256B (1)(a) is intended for the protection of members (shareholders) of the company, if viewed in other contexts where a similar phrase is used it may pose some difficulties of interpretation. Under s 232 and in *NSW Rugby League Ltd v Wayde*\textsuperscript{84} a question which confronted the courts was whether the phrase, ‘company’s shareholders as a whole’ was to be synonymous with the interests of the company as a commercial entity or, whether, interests of members as a whole was relaxed to the resolution of conflict between one or more classes of company members. In the *Rugby League* case, Brennan J took the view that the expression ‘the interests of the members as a whole’ was unlikely to provide a criterion for judicial intervention to resolve a conflict between members inter se. The general view as discernible from case law, also shows that the expression, ‘company’s shareholders as a whole’ may tend to mislead because, while a proposed reduction may be in the company’s interests, it may be adverse to the interest of one or more members or class of members.\textsuperscript{85}

The requirement under s 256B (1) (b) that a reduction of share capital does not materially prejudice the company’s ability to pay its creditors mirrors that of s 260A(1) in relation to

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\textsuperscript{83} The policy behind s 256B (like that of the buy-back regime), is that the interests of shareholders and creditors need to be protected.

\textsuperscript{84} (1985) 1 NSWLR 861.

\textsuperscript{85} Refer, for example, to *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112 at 138.
financial assistance, and relates closely to the discussion of solvency in Chapter 8. The 'material prejudice' provision, under s 256B (1) (b) is aimed solely to the protection of creditors unlike under s 260A(1) (a) (i-ii), where it has the objective of protecting both creditors and shareholders. It is to be noteworthy that the most minimum standard for the distribution of assets pursuant to reduction, is the requirement that the corporation remains solvent after any reduction or distribution. This is assumed will not materially prejudice a company's ability to pay its creditors. Reliance on the liquidity or cash flow method may convey some commercial sense but, setting the degree of liquidity to be maintained may at times prove to be problematic. It is therefore unrealistic at times to apply this rule of thumb in considering the extent of credit.

Sections 256B-E inclusive, contain procedures which permit the company to reduce its share capital after notification to ASIC and approval by the appropriate majority of shareholders. The law provides a simplified system for the reduction of capital, which depends on the distinction between an equal reduction and a selective reduction and, requires that in both cases, the company must disclose all known information that is material to the decision, and must lodge the notice of meeting with ASIC. Where the requirements are not strictly adhered to, those involved in the breach of the law are subject to the civil penalty regime. Creditors and shareholders are provided with a remedy to seek an injunction relief under s 1324. ASIC may refer the matter to the Takeovers Panel, and if the company becomes insolvent the directors may be liable under the s 588G insolvent trading provisions.

An examination of the case law interpreting the current provisions, especially sections 256B & 256C suggests that the task of giving effect to all of its language may prove very problematical. This is due partly to the confusion of concepts and terminology and partly to a failure to discriminate between the different operations of (a) reducing the amount of

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86 It is important to note that since 'material prejudice' is the key to both reduction of capital and financial assistance, aimed at protecting both creditors and shareholders under s 260A(1), a detail discussion of this concept will be provided under chapter 4 (financial assistance). Also, the discussion of s 256B (1)(b) and creditor protection, is elaborated upon in s 3.4.1.(below).

87 If the company is listed under the Australian Investment Exchange, the ASX Listing Rules 7.26 requires that such it complies with the requirements under that rule.
the issued capital by action of the shareholders, (b) the question of retiring shares and, (c) the issue of adjusting the value of outstanding shares and the market value to conform to issued share capital as reduced and, (d) distribution of assets to the shareholders out of the solvency margin. Secondly, the ‘fair and reasonable test’ suffers from a lack of adequate judicial and legislative clarity.\(^8\)

3.3.2. Equal & Selective Reduction of Capital.

Unlike s 195 of the Corporations Law, which only referred to reductions of capital, s 256B (2) prescribes two different types of share capital reduction with different procedural requirements.\(^8\) The first type is an ‘equal reduction’ which relates only to ordinary shares with members treated on equal terms and the other, is a selective reduction, where members are not treated equally and proportionally (though, they might to a certain extent be treated the same). Both equal and selective reductions also require compliance with Australian Stock Exchange Listing Rules 7.26 for those shares listed on the exchange.

3.3.2.1. An Equal reduction of capital (s 256B(2))

An equal reduction is a reduction which relates only to ordinary shares and applies to each holder of ordinary shares in proportion to the number of ordinary shares they hold and, where the terms of the reduction are the same for each holder of such shares.\(^9\)

\(^8\) It is also possible to make certain recognizable observations about the current regime. Firstly, the process under s 256 generally assumes there is no involvement of judicial approval. Secondly, the capital reduction mechanisms are driven by a ‘majoritarianism’ and, ‘shareholder democracy’ (that is, the total control, voting and resolution procedures are assumed to be under the dominance of the majority shareholders (majoritarianism). Also, the policy objective of the current law, tends to focus more on shareholder protection (‘shareholder democracy’), this is evidenced by the requirements under s 256B (1) (a) relating to the fair and reasonable to the shareholders as a whole test and, the s 256B (1) (C) and 256C (relating to shareholder approvals.).

\(^8\) It is importantly noteworthy that the explanatory memorandum to the Company Law Review Bill 1997 (now, the ‘CLR’ Act 1998) which introduced s 256C explained the nature of that section by reference to the two types of reduction of capital thus: “a selective reduction will require a special resolution or unanimous shareholder agreement at a general meeting, because they have the capacity to advantage some shareholders over others...the resolution approval reflects the wishes of the company’s disinterested shareholders and corresponds to the approach taken in s 257D of the Bill in relation to share holder approval for a selective share buy-back. The 1998 Act also includes a procedure to protect minority shareholders against their shares being cancelled under the guise of a capital reduction. (See Bill Schedule 5 Item 18).

\(^9\) Corporations Act 2001 (Cth), s 256B (2) (a-b). In determining whether the terms of a reduction are the same for each ordinary shareholder, the law requires that differences in the terms are ignored; if they are attributable to the
An equal reduction need only be approved by an ordinary resolution passed at a general meeting of the company. This may be deemed to override any provision in the company's constitution since this type of reduction is not subject to the company's constitution. There are no special qualifications for voting. The resolution will be passed if it is voted for by a simple majority of the shareholders who vote in person or by proxy. This is subject to any contrary provision in the company's constitution which may require the passing of a special resolution. In *Re RGC Ltd* for example, a constitution required the passage of a special resolution despite the ordinary resolution at the general meeting because the legislature intends it to be so. Under the s 256C (1) procedure, there is little or no direct mechanism for the protection of creditors' interests apart from the fact that ASIC is to be notified under s 256C(3) of the convening of the ss 256C(1) and (2) general meetings before they are conducted. If a company improperly reduces its capital, it contravenes s 256D (1), but the company is not guilty of an offence. Any person who is involved in the contravention of the law, contravenes the civil penalty provision and, if the involvement was dishonest, the person also commits a criminal offence.

In *Re Etrade Australia Ltd*, a scheme of arrangement and reduction of capital were proposed under which notionally, a company reduced its capital by allocating cash pro-rata to its shareholders according to a formula in the documentation, and then by force of the scheme that cash was applied on behalf of the shareholders in purchasing shares previously acquired by the scheme company. The notional distribution and the application of the cash were such that the shareholders never physically received the cash. Santow J held that the element of the proposal which involved a reduction of capital was an equal reduction because the notional distribution was in proportion to the number of ordinary shares held and the terms of the reduction were the same for each shareholder.

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91 Ibid. s 256C(1).
92 This assumption is not often correct since the constitution may require the passing of special resolutions.
93 (1998) 29 ACSR 445. See also, *Westchester Financial Services Pty Ltd v Acclaimed Exploration NL* (1999) 32 ACSR 499. (where a provision in the company's constitution required that a proposal to reduce capital be dealt with by a special resolution).
94 Section 256D(2)(b).
95 See, respectively, as 256D (3) (civil penalty provision) and s 256D (4) (criminal penalty).
96 (1999) 30 ACSR 516.
3.3.2.2. Selective share capital reduction (s 256B(2))

Any reduction of capital which is not an equal reduction is accordingly a selective capital reduction.\(^97\) Therefore, any reduction which relates to shares other than ordinary shares is a selective reduction even if all of the holders of the shares are treated equally. Though not all selective reduction may involve cancellation of shares, the shares of selected members of the corporation are cancelled. As a consequence, the balance of power in a company can change, raising the possibility of a takeover, or at least changes in the percentage of shares in a company to which the remaining shareholders are entitled.

Because a selective capital reduction can have a negative effect on shareholders as a whole and, particularly on those classes whose shares are to be cancelled, the law requires such types of reduction to be approved by either a special resolution of shareholders who will not directly benefit from the reduction with no votes being cast in favour of the resolution by any person who is to receive consideration as part of the reduction or whose liability to pay amounts unpaid on shares is to be reduced or, by a unanimous resolution of all ordinary shareholders at a general meeting. If the reduction involves the cancellation of shares, the law also requires that the reduction be approved by a special resolution at a meeting of the holders of the shares.\(^98\) It is unclear if a selective reduction provision provides an unqualified protection to those members whose interests may be adversely affected. It is argued that since a vote is ‘cast’ only when counted in favour of a reduction, the directors can successfully go on with a proposal unopposed by

\(^{97}\) Section 256B (2) (c). There are several reasons for a company engaging in a selective reduction. Perhaps the clearest is that if a company becomes a wholly owned subsidiary, tax losses can be transferred to and from companies in the same group. Also, as a compulsory acquisition under s 664 cannot be used to acquire options and convertible notes (as it only relates to shares), a selective reduction can be used to ensure 100 percentage ownership of a company (see, Digby, “Eliminating Minority Shareholdings” (1992) 10 C&SLJ 105, 107). Moreover, elimination of minority shareholders is also simply to reduce administrative cost in the company (see, Catto v Ampol (1989) 7 ACLC 717 at 727 per Rogers AJA).

\(^{98}\) Corporations Act 2001 (Cth), ss 256C (2) (a) & (b). Generally, under a selective reduction of capital, one special resolution can suffice unless shares are to be cancelled or, a variation of class rights is involved. It is of particular noteworthy that s 256C (2) take a legislative shift from former s 195 of the Corporations Law whereby, if a company wanted to cancel a class of preference shares, it could do so by a special resolution of a general meeting. The preference shareholders could only vote on that resolution if their voting rights allowed them to. The cancellation did not also have to be approved by the preference shares as a class unless their class rights provided otherwise. The nature and scope of s 256C (2) indicates that at least the capital maintenance is concerned more with shareholder protection, rather than creditor protection. (For a further elaboration and case analysis of selective capital reduction procedure, see below subpart 3.4.2. with the theme; “shareholder protection”).
preventing or refusing to count any votes which attempt to invalidate a proposal. It is less clear how the law attempts to address this kind of situation. The rationale of a selective share reduction is illuminated in Winpar Holdings v Goldfields Kalgoorlie Ltd which also, exposed some of the problems with the operation of s 256C(2). For example, it is argued that, the section gives shareholders who retain shares after the reduction is approved a power to veto the reduction thereby adversely affecting those minority shareholders whose shares are cancelled with little power of resistance. This argument remains unpersuasive in the sense that if the shareholders are vetoing the reduction then the shares are not cancelled. However, there is much uncertainty if shareholders as a whole or as a class would be adequately protected under s 256C where the proposal is to reduce capital selectively by canceling all the shares in a class or there is a reduction under s 258F, which allows a company to reduce its share capital by canceling any paid up share capital that is lost or is not represented by available assets.

In accordance with Re Ballarat Medical Products Ltd, nothing prevents a company from approving a reduction which is subject to conditions. There is also an anomaly in the approval requirement in section 256C (2) where Santow J, in Re Etrade Australia Ltd

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99 See, Re Tiger Investment Co Ltd (1999) 33 ACSR 438. Even though 75 percent of the votes cast must be needed at the meeting in favour of the proposal, this does not prevent the directors to manipulate the voting procedures.

100 (2000) 18 ALC 665 at 673; [2001] NSWCA 427. See also, Village Roadshow Ltd v Boswell Film GmbH [2004] VSCA 16. This is the most recent authority which has raised further questions of the difficulties of the share holder approval procedures under s 256C (2) (selective reduction of capital) and, (s 227D on selective buy-back).

101 See, Digby, above n 97.

102 (1997) 23 ACSR 182. Prior to the 1998 amendments, the courts could not make an order confirming a reduction which at the time of the confirmation order was still conditional on future events which may or may not occur. It was also a requirement for companies to publicise or advertise reasons for a reduction of capital. But, the current law does not require companies to advertise reasons. Rather, in its place, the notice of the minutes of resolutions and accompanying documents must be lodged with ASIC under s 256C(5) and ASIC then enters the data in its Alert System, to which creditors may subscribe. Creditors who then became aware of any detrimental effects in a proposed reduction, may then complain to ASIC who may then take proceedings to restrain the company in pursuant to s 1324 if they find that the reduction is ‘unlawful’—in the sense of the company being unable to pay its debts. Creditors, can further persuade ASIC to apply to the Corporations and Securities Panel under s 657A & 657C (2) reasoning on the grounds that the reduction would constitute an ‘unacceptable circumstance’. In Re St Barbara Mines Ltd and Taipan Resources NL (2000) 18 ALC 123, ASIC explained ‘unacceptable circumstance’ to be one which defeats or compromise the achievement of the policy purpose of Ch 6 to 6C of the Corporations Law. However, this ASIC procedure can only protect those creditors who are subscribed to the Alert System and who became aware of any purported reduction scheme. Therefore, creditors not subscribed to the System may find it difficult to invoke s 1324.

opined that the new selective capital provision only works where it is implemented to require a shareholder to exit its investments voluntarily (i.e., only works if they pass a special resolution) and questions if it really works in the context of eliminating minority shareholders. Statutory redress for illegal distribution most commonly takes the form of director or shareholder-recipient liability. However, these general provisions on distribution, have been drawn in terms which render their protection attenuated. In all, the prospect of adequate protection under the current provisions leaves a large degree of doubt on material issues.

3.3.3. Loss Reduction of Capital (s. 258F).

Loss reduction describes a reduction of capital caused by a company canceling paid-up share capital that is lost or unrepresented by available assets. Accordingly, s 258F permits a company to reduce its capital by canceling any paid-up share capital which is lost or not represented by available assets\(^\text{104}\) without satisfying the statutory procedures of s 256B(1). The law assumes creditor’s interests are not seriously at stake under a loss reduction, because, no assets leave the company, there can be no depletion in its resources.\(^\text{105}\) In *Re Southern Acceptance Corporation Ltd*,\(^\text{106}\) to justify the desirability for reducing lost capital, the court took the view that if a company has accumulated losses of its paid up capital, it may wish to lower the level of its issued capital closer to the value of its depleted net assets. That strategy may improve its financial profile in its balance sheet or prepare it for a merger with another company on a better commercial basis.

In determining whether capital has been lost or is not represented by available assets it is necessary to distinguish between a diminution in the value of fixed assets, or trading losses, and circulatory capital.\(^\text{107}\) A diminution in the value of fixed assets such as a mine

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\(^{104}\) Lost capital and capital which is not represented by available assets are separate concepts. (See, e.g., *Re Hoare & Co Ltd* [1904] 2 Ch 208).

\(^{105}\) The situation is different where the company also cancels shares.

which is in the nature of a wasting asset), and equipment (which depreciates in value by reason of its use), or losses incurred in the course of trading operations, may result in capital being lost or not represented by available assets, thus justifying a reduction of capital. On the other hand, circulating capital is assumed to be represented by current assets such as stock in trade and inventory, with the result that it can not be regarded as falling within s 258F.

The lack of an explicit judicial or legislative explanation between the words, ‘loss reduction of capital’ and ‘capital not represented by available assets’, and between ‘fixed and circulating capital’ may pose some difficulties in applying s 258F. Also, the absence of a consistent and coherent approach in determining when there is a diminution in the value of company’s assets or, whether trading losses need to be made good for purposes of dividend distribution, leaves much scope for uncertainty. Another anomaly suggests that the s 258F procedure which does not need to comply with the relevant s 256C procedures may adversely affect both creditors and shareholders.

Traditionally, a court would not approve a loss reduction unless the company established that the relevant capital was not represented by available assets and that the deficiency was likely to be permanent. Creditors could be prejudiced if capital has not been lost permanently. In *Caldwell v Cardwell &Co (Paper Makers) Ltd*, Lord Parker acknowledged that creditors would be prejudiced if a present capital deficiency were to

107 See generally, *Lee v Neuchatel Asphaltic Co* (1889) 41 Ch D 1; *Marra Development Ltd v BW Rofs Pty Ltd* (1977) 2 NSWLR 616.
108 See, *Lee*, (ibid); *Verner v General and Commercial Investment Trust* [1894] 2 Ch 239.
109 See, *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch 266.
110 According to s 258F and the decision in *Re Hoare & Co Ltd* [1904] 2 Ch 208 a devaluation of capital assets meant that the paid up capital of the company was not represented by assets of comparable value. A literal interpretation of s 258F as traditionally conferred by s 3 of the *Companies Act 1877* (UK), which provides that the power to reduce capital, ‘shall include a power to cancel any lost capital, or any capital unrepresented by available assets’ has been difficult to translate into practice. In the *Re Hoare case*, Buckley J held the two terms ‘lost reduction’ and ‘capital unrepresented by available assets’ are alternatives which implied that a company has power to reduce either ‘lost capital’ or ‘capital not represented by available assets’. While it is difficult to say with precision when a company’s capital may be reduced in the sense that it is unrepresented by available assets, so it is difficult to say whether in such a situation the rights of shareholders were not varied.
111 Refer to Chapters 1 & 5 of this study where the difficulties of distinguishing between fixed and circulating capital was advanced.
113 For example, see, *Re Jupiter House Investments (Cambridge) Ltd* [1985] 1 WLR 975 at 979 per Humfray J (The word, ‘permanent’, meant ‘permanent so far as was permanently foreseeable’).
be made good in the balance sheet of a company after a loss reduction and, for example, was used to fund a dividend to shareholders.\textsuperscript{115} His Lordship intimated that, if there was doubt as to whether a capital deficiency was permanent, a court could approve the reduction provided special measures were taken to protect the company’s present creditors.

Thus, in \textit{Re Grosvenor Press plc}\textsuperscript{116}, Nourse J held that the courts’ confirmation on a loss reduction was conditional on the undertaking by the company that, should the lost capital be restored, it would be held in a reserve account until all of the creditors at the date of the reduction had been paid in full. Arguendo, without the court’s sanction under the current law and, with the repeal of most of the safeguards available to creditors, there is a very high probability that under the current regime, the courts may misdirect their construction of loss reduction thereby hurting both present and future creditors. Furthermore, s 258F cannot seemingly, be used to write-off prospective losses. The provision leaves it to the court to determine whether capital has been lost.

As earlier indicated, a company under the old law would not be allowed to engage in a loss reduction unless its balance sheet disclosed the loss. Unfortunately, for purposes of transactions affecting share capital, the law does not subscribe to a balance sheet test to determine whether a company is solvent and would be capable to pay its debts as they become due. The cases do not also suggest that a company should not engage in a loss reduction unless it is solvent in its cash flow or liquidity sense. It is also questionable whether there is now any requirement under the current law that a loss must be permanent. It is also very unclear why a loss reduction of capital should not be subjected to the procedures found under s 256B. Understandably, where a capital loss is permanent, a formal loss reduction of capital cannot prejudice creditors as no assets leave the company.

\textsuperscript{114} [1916]WN 70.
\textsuperscript{115} Ibid. at 112.
However, where a company cancels shares and does so for no consideration, the cancellation is a reduction of capital and both creditors and shareholders are affected. Creditors are affected because the law says s 256B (1)(b) does not apply (that is, there is no requirement that the reduction must materially prejudice the company’s ability to pay creditors).\textsuperscript{117} It is ironical and inconsistent for the legislation to require creditors to be protected under s 256B(1)(b) and the s 588G procedures for purposes of reduction of share capital not otherwise authorized by law but not under s 258F. Shareholders are also adversely affected. They were supposed to be protected by the s 256B(1)(a) procedure which requires a reduction to be fair and reasonable to the company’s shareholders as a whole and, the s 256C(2) procedure which requires shareholder approval. Unfortunately, minority shareholders have little recourse from the law against loss reduction. They cannot even evoke the s 1324 (1B) procedures. Perhaps the only relief available to them under s 258F is to evoke the s 232 oppression remedy provisions and other breaches of directors duties.

Furthermore, while a loss reduction which has not resulted in a capital reduction does not inhibit a company from declaring dividends out of trading profits,\textsuperscript{118} a capital profit cannot be distributed by way of dividend unless a company’s shareholders’ funds exceed its paid up capital.\textsuperscript{119} Accordingly, a company which has lost capital may wish to reduce it to allow payment of dividends out of capital profits. Where there is such a reduction and the company has different classes of shares with unequal interests in the company’s capital, the burden of the reduction of capital should fall on those shares which could not be expected to confer an entitlement to a dividend or the repayment of capital on a winding-up.\textsuperscript{120}

\textsuperscript{116} [1985] 1 WLR 980; [1985] BCLC 286.
\textsuperscript{117} The Explanatory Memorandum to the Corporations Law Review Act 1998, gives as examples of lost capital cases where assets are stolen or destroyed by fire, but specifically state that s 258F will not apply in the case of trading losses incurred in the ordinary course of business (Refer to, Ford et al, Fords Principles of Corporations Law, 12\textsuperscript{ed} (Australia : Butterworth’s, 2005) at 1159.
\textsuperscript{118} "Marra Development, above n 111.
\textsuperscript{119} Australasian Oil Exploration Ltd v Lachberg [1958] 101 CLR 119.
\textsuperscript{120} Refer generally to, Re Rhodesian Manufacturing Co Ltd [1927] SASR 310.
3.3.4. Relationship between a Reduction of Capital and Variation of Rights.

Under general law, it is a recognizable principle that the assets of a company in a winding-up are subject to payment of debts and costs, distributable amongst its members according to their rights and interests. The company’s constitution determines what those rights and interests are. In the absence of special provisions, the rule of equality requires that losses must be borne and profits shared by the shareholders in proportion to the nominal amount of their shares, and not in proportion to the amount paid up thereon. The general law position is that in a loss reduction of capital, ordinary shareholders must usually first bear the loss and, when capital is being returned, priority goes to the preference shareholders. In Re Chaterfield-Whitfield Collieries Ltd, Evershed LJ said:

Where ... the contract between the preference shareholders and the company makes no express provision in regard to the rights and obligations on a return of surplus capital, it seems to me impossible on general principles to imply a commercial term that, in the event of a surplus, preference capital be refunded first.

Although it has never been possible to provide the blueprint for a preference share, in view of the diversity of rights which may be attached to them, the provisions which regulate the variation of rights of shareholders may be conferred by the issuing company’s constitution or by statutory law. Under s 246B(1), if a company has a constitution that sets out the procedure for varying or canceling rights attached to shares in a class, those rights may be varied or cancelled only in accordance with those procedures set therein. Moreover, while the company’s constitution may prescribe that in a winding-up the assets shall be applied in some manner other than according to the nominal amount of shares held by the shareholders, or a class of shareholders as for example, according to the

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121 In The King v Tait & Ors [1936] HCA 62; (1936) 57 CLR 715., the court said that it is the province of a company’s constitution to regulate the manner in which funds of a company are to be applied in a winding up after the discharge of liabilities and costs, charges and expenses.
122 [1948] 2 All ER 59, 606. There, the general practice of the court has been to confirm a surplus return in accordance with the priority in a winding-up. Apart from special cases where by agreement between classes the incidence of reduction is arranged in a different manner, this is and has for years been the normal and recognized practice by the courts.
123 Ibid.
124 Section 246B (2) further states that if the constitution does not set out procedures for varying or canceling such rights, those rights may be varied or cancelled only by special resolution of the company and, by special resolution passed at a meeting of the class of members holding shares in that class.
amount called up before winding up on the respective shares, the position of a deferred status of say a preferential shareholder on a return of capital in priority on a winding-up remains very questionable. It is therefore a question of some importance to preference shareholders who risk losing their investment when capital is being reduced whether their rights can be varied and adequately protected by the company’s constitution or statute and, if so by what means.

3.3.4.1. Does a Reduction of Share Capital vary (abrogate) Class Rights?

Section 256A of the Corporations Act allows a company to reduce its share capital in accordance to certain statutory preconditions. Where rights are to be varied or abrogated, the law recognizes that such rights can be varied in accordance with statute or, in accordance with the company’s constitution. Sections 246B-F inclusive, set out the requirements for variation of rights. Under case law, a right of a class of shareholders is varied or affected if the substance of the right (as distinct from the enjoyment of the right) is changed. The mere fact that an act of a company affects the commercial value or enjoyment of a right does not mean that the right has been varied, abrogated or affected.

The English equivalent, s 125 (3) which lays out specific rules for the interaction between a reduction of capital and variation of rights provides that, the holders of a particular class

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125 Cf. Re Kinatan (Borneo) Rubber Ltd (1923) 1 Ch 124; Re Australian Group and General Assurance Group Ltd (1932) SR (NSW) 435.

126 The position of shareholders has however, traditionally been more problematical in view of the special nature of the shareholders’ contract with the company.

127 The central thesis of the argument is to look at the effect or consequences that a selective reduction of capital under s 256C (2) would have on those members of a class whose shares are cancelled (Preference shares) due to the capital reduction procedures. Preference shareholders have stronger rights in many instances. They usually have a right to share in the distribution of dividends in advance of ordinary shareholders. In addition, they will often have special voting rights on issues which affect their status and special rights to the return of their investment in a winding-up.

128 See, Corporations Act, s 246. Section 246B (2) states the procedure that a company must follow to vary or abrogate rights attached to a class of its shares. As acknowledged earlier, if the company has no constitution, or a company has a constitution that does not set out the procedure for varying or canceling those shares, a company may only vary or cancel those rights by special resolution of the company (see, s 246B(2)).

129 Re John Smith’s Tadcaster Brewery Co Ltd 1953]1 Ch 308.
must consent to the ‘variation’ or ‘abrogation’ of the rights attached to that class on the reasoning that, the class rights define and protect the constitutional status of the class of share in question.\(^{131}\) “Variation of right” presupposed the existence of a right, its variation and its subsequent continued existence. "Abrogation of a right”\(^{132}\) presupposed the continued existence of the share to which it was attached. The question as to whether a reduction of capital varies class rights is not well spelled out by the legislation. However, the courts have developed certain principles which are conflicting.\(^{133}\)

### 3.3.4.1.1. The Popular Approach.

Under this approach, the courts traditionally developed a ‘popular’ principle to the effect that, a proposed scheme of reduction of capital under which preference shares were repaid and cancelled was held not to amount to an abrogation or variation of the rights of the preference shareholders.\(^{134}\) It is assumed that the mere fact that an act of a company affects the commercial value or enjoyment of a right does not mean that the rights have

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\(^{130}\) In *White v Bristol Aeroplane Co Ltd* [1953] Ch 65, it was held that the issue of shares of one class increased the relative voting power of that class but did not ‘vary’ or ‘abrogate’ the legal rights of another class of shareholders.

\(^{131}\) Companies Act 1985 (UK), s 125(3). See also, *House of Fraser plc v ACGE Investments Ltd* [1987] 3 BCLC 201.

\(^{132}\) Ibid.


\(^{134}\) A line of authorities tend to assume that this is the correct approach. Refer for example, to the following: *Chatterley-Whitfield Collieries Ltd* [1948] 2 All ER 593, *Re Daniel Clifford Investments Ltd* [1948] SASR 278; *Dimbulla Valley (Cellon) Tea Co Ltd v Laurie*[1961] Ch 353; *Re Saltside Estate Co Ltd* [1968] 1 WLR 1844; *Re William Jones & Sons Ltd* [1969] 1 WLR 146, *House of Fraser plc v ACGE Investments Ltd* [1987] AC 387. (Henceforth, those authorities which support the common law view will be referred to as the ‘Re Saltside principle’). The so called *Re Saltside principle* has not been fully welcomed from a line of other authorities which include: *Re Scottish Insurance Corp Ltd v Wilsons & Clyde Coal Co Ltd* [1949] 3 All ER 829; *Re Old Silkstone Collieries Ltd* [1954] 1 Ch D 169; *Re William Jones & Sons Ltd* [1969] WLR 146; *Re Northern Engineering Industries plc*[1993] BCLC 1151; *Re Palace Hotel Ltd* [1912] 2 Ch 439; *Re Schweppes Ltd* [1914] 1 Ch 322. (These authorities which take an opposite view to the issue in question, will hereinafter be known as the ‘Re Old Silkstone principle’). The conflicting and inconsistent approach in case law leaves the issue of the relationship between a reduction of capital and variation of rights highly questionable.
been varied, abrogated or affected. Thus in, White v Bristol Aeroplane Co Ltd,\textsuperscript{135} the issue of shares of one class increased the relative voting power of that class. The court held that this did not vary or affect the legal rights of another class of shareholders. Accordingly, in Re Mackenzie & Co Ltd,\textsuperscript{136} the court was of the opinion that a reduction of capital does not modify or affect class rights merely because some or the entire amount paid up on shares is returned or written off. The leading authority is Re Saltdean Estate Co Ltd.\textsuperscript{137}

There, the share capital of the company consisted of ordinary and preference shares which were all issued fully paid. The company’s constitution provided that on the winding up of the company, the preferred shareholders should be repaid first and rateably the amounts paid up or credited as paid up on their shares. It also provided that both the preference and ordinary shareholders were to each receive a 10% dividend and then the balance of the profits were to be divided equally between the two classes of shareholders. The business of the company was very profitable with massive undistributed profits. A special resolution was passed to reduce the company’s capital by repaying the capital paid up on the preferred shares with a premium of five shillings per share.

Understandably, the preference shareholders objected on the basis that they had a right to refuse to consent to this proposed reduction. (A petition seeking the court’s sanction to the proposed reduction was opposed by the holder of 80 preferred shares on the following grounds:

- that the reduction was a variation of the rights attached to the preferred shares which required an extraordinary resolution to be passed at a separate class meeting and that no such meeting had been held;
- that the failure to obtain the preferred shareholders’ approval prevented the dissentient minority from availing themselves of the protection intended to be given by s 72 of the Companies Act 1948 (UK) which was the relevant statutory provision\textsuperscript{138} and,

\textsuperscript{135} [1953] Ch 65.
\textsuperscript{136} [1961] 2 Ch 450.
\textsuperscript{137} Saltdean Estate Co Ltd. Re [1968] 1 WLR 1844; 3 All ER 829, 832. (Hereinafter as the ‘Saltdean or Fraser principle’). A similar view point was tacitly assumed on similar facts in Re William Jones & Sons Ltd [1969] 1 WLR 146 and, Dimbua Valley (Ceylon) Tea Co Ltd v Laurie [1961] Ch 353.
\textsuperscript{138} At the time, s 72 provided the only statutory control over the variation of class rights and, like the present s 246B of the Corporations Act, it provided that when class rights were varied in accordance with a variation provision in the constitution, the holders of 10% or more of the class could, so long as they had not voted in favour of the variation, apply to the court to cancel it. It was therefore argued that since a proposed cancellation of the
Chapter 3

3.3. Mechanics for Reduction (Variation of Rights)

- that the proposed reduction was inequitable and unfair to the preference shareholders, in that it discriminated against the holders of the preferred shares by preventing them from sharing in the fruits either of the company’s future or its past prosperity. It was further contended that there was no prospects of the company being wound-up and that continued large distributions of profits were to be anticipated.

Buckley J held that, on the facts, the proposed cancellation failed to fall within the variation provisions of either the constitution or the statute. He said:

In my judgment, the class consent or variation of rights provision has no application to a cancellation of shares or a reduction of capital which is in accord with the rights attached to the shares of the company. Unless this reduction can be shown to be unfair to the preference shareholders on other grounds, it is in accordance with the rights and liability to prior repayment of capital attached to their shares. The liability to prior repayment on a reduction of capital is a liability of a kind which Lord Greene said that anyone only has himself to blame if he does not know of it. It is part of the bargain between the shareholders and forms an integral part of the definition or delimitation of the bundle of rights which made up a preference share. Giving effect to it does not involve a variation or abrogation of any right attached to such shares. To me therefore, the scheme was not unfair or inequitable.\(^{139}\)

It was assumed that there can be no variation or abrogation where there is no change in constitutional status. Where a company’s capital consists of ordinary and preference shares, and further ordinary shares are issued or existing ordinary shares are given enhanced voting rights, this may not affect the constitutional status of preference shares. They will still be entitled to their preference dividend in advance of other shareholders. They may also have enhanced voting rights on all major issues, with such rights being structured to ensure that preference shareholders’ votes are unaffected by any increase in the number or voting power of ordinary shares.\(^{140}\)

\(^{139}\) Re Salidam Estate Ltd, above n 146 at 833, 834. According to Buckley J, what was involved in the transaction was a cancellation of shares rather than a variation of rights attached to those shares.

\(^{140}\) It is the ‘class rights’ definition and the effect which is critical, not that of ‘variation’ or ‘abrogation’. If something is not a right, then it cannot be varied or abrogated. There are also exceptional cases where the converse is true.
Chapter 3  3.3. Mechanics for Reduction (Variation of Rights)

It is apparent that Buckley J arrived at his decision in *Re Saltdean* without due consideration of the need for such a reduction of capital or, without considering whether the proposed reduction of capital would produce any advantages to the company’s shareholders as a whole as espoused by Cozens-Hardy J in *Re Barrow Haematite Steel Co.*\(^\text{141}\) Arguably, to have based his judgment on the settled principle of law relating to a return of loss or surplus capital in accordance to priorities on a winding-up, does not justify the ‘popular’ view. Arguendo, the *Re Saltdean* principle has only a limited application and is flawed in certain material respects. Firstly, the statutory guidance given by the courts under the priority principle in a winding-up is only meager. As aforesaid, reliance on the priority principle portrays many anomalies. The ‘equality principle’ envisaged above, has been questioned in *Re Fowlers Vacola Manufacturing Co Ltd*\(^\text{142}\) which also established the principle that preference shareholders cannot demand, as a right, that they receive priority in a surplus return.

Secondly, while there may be little problem in applying the ‘popular approach’ to a situation where the company’s constitution so prescribes the necessary procedures for a variation of rights, where the company’s constitution remains silent as to the procedures for a variation of rights and also, where after the proposed reduction, the company contemplates to remain a going concern instead of winding up, arguably, a cancellation of shares of minority shareholders can be equated to the expropriation rights envisaged in the “*Gambotto principles*” and compulsory acquisition provisions under s 667. Under a combination of selective reduction and a scheme of arrangement, there is a possible chance for a certain class of shareholders to be subjected to oppressive conduct.

Thirdly, while a return on capital which accords with the priority repayment in a winding up contemplates that those shareholders whose shares are to be cancelled or whose rights were to be totally extinguished from the company need to be paid fully, there is nothing to prevent the preference shareholders from contesting a proposed reduction as a variation of

\(^{141}\) [1900] 2 Ch 846
\(^{142}\) [1961] VR 97.
their rights especially where they were not fully paid. The same point was tacitly assumed on similar facts in Re Daniel Clifford Investments Ltd. There, a proposed reduction of capital by the cancellation or total extinguishment of the rights of the minorities was to be effected without a full repayment of their capital. Presumably, since those minority shareholders continued to have the rights to all the benefits accruing from the company any attempt to reduce their shares without their consent, can as their claims remain outstanding, have the capacity of making such a proposed reduction affect the rights of such shareholders. But Napier CJ, said:

The right, given by the preference shares, is the right to dividends and to the repayment of capital without any further rights to participate in the profits. In other words, the rights of the preference shareholders is to the dividend so long as they hold their shares, and to the repayment of their capital, in full, whenever they cease to be members of the company, but there is no stipulation which prevents the company from winding up or reducing its capital in any manner allowed by law ... It follows that, so long as the right of the preference shareholders, to the payment of their dividends and to the repayment of their capital, is respected and secured to them, it is no breach of the contract to pay off the capital and, thereby, to terminate the right to the payment of this dividend ... It seems to me that the transaction was analogous to a loan, in which the lender was given security for the payment of principal and interest ... When the contract is silent upon the subject, the borrower should have his equity of redemption ... Accordingly, the company was in a position of a borrower and the preference shareholders in the position of lenders and as such, this was the true substance of the agreement between the preferential shareholders and the company.

143 Mindful of the purpose of the s 256A(1) fairness and reasonableness test espoused by the Explanatory Memorandum which does not look at the 'commerciality' aspect of the reduction (i.e., whether all shareholders were duly paid) but focusing on the effect that such a reduction would have on shareholders as a whole. A fourth reason while the Re Salidean principle may be flawed concerns a situation where a company issues redeemable preference shares and wishes to redeem them. A redemption of these shares does constitute a reduction of capital: Comptroller of Stamps v Ashwick (No 4) Pty Ltd (1987) 12 ACLR 570 at 576, where the full High Court commented that it 'is to our mind, axiomatic ... that the redemption of redeemable preference shares reduces the share capital of the company'. (Citing Re Serpell & Co Ltd [1944] Ch 233). Arguably while there are mixed views as to whether a redemption out of capital reduces the net assets of the company, presumably, payment of the redemption out of capital would normally be prohibited, as being unlawful reduction which falls outside the normal channels for reducing capital under s 256 or, 258F(refer to Re Morganite Australia Pty Ltd (1989) 18 NSWLR 343.

144 [1948] SASR 278. It is to be noteworthy that in the absence of a constitution which has a contrary effect, a cancellation of particular shares of a company on a reduction of share capital is not something which requires the consent of the shareholders entitled to shares of the class which is to be cancelled if the reduction and cancellation is in accordance with the rights and liabilities attached to that class of shares. Similarly, a reduction of capital by way of a cancellation of all of a company's preference shares in consideration of a return of the proper amount due to holders of such shares could not be taken to vary the rights attached to those shares. This follows from the decision of the House of Lords in Prudential Assurance Co Ltd v Chatterley-Whitfield Collieries Ltd [1949] 1 All ER 1094.

145 Ibid at 278-279.
Logically, giving a literal construction to the above statement, the rights of the preferential shareholders are only conditional, conditional upon a reduction of capital being made. Even if that is correct, there is misdirection here. That anomalous direction relates to the fact that his Honour erroneously equates preference shareholders with secured creditors. That does not adequately reflect the interaction between a reduction of capital and variation of rights procedures especially, in accordance to the priority position in winding-up. His Honour may be referred to what Evershed LJ said in Re Chatterley-Whitfield Collieries Ltd. that preference shareholders are more than secured creditors, they are corporators of the company’s enterprise jointly with other shareholders. He put it this way:

The theory at the bottom of this idea seems to be that a preferential shareholder subscribes his capital on the basis that he/she is to receive a preferential dividend of an agreed amount and that it is unfair to him to oust him from the company and thus deprive him of his contractual expectation of dividend.

While this assertion may defeat the Saltdean principle, Buckley J held that Evershed LJ’s reasoning was unrealistic in two respects. Firstly, he opined that the risk of a redemption was part of the bargain between the preferential shareholders and the company and secondly, the general position of the courts has been to confirm a reduction of capital in accordance with the priority given in a winding-up. As a result, a preferential shareholder could have no real expectations that his investment would remain indefinitely. This view was followed by Lord Greene, who found that there was a commercial advantage of the company paying off the preference shares. As to the question of what the company would have done, he said:

The business answer to this question does not admit of doubt particularly where a substantial part of the capital consists of preference shares bearing a higher rate of dividend than the company is reasonably likely to earn in the future. It will do what this company seeks to do, that is, to reduce its capital by paying off as much of its preferential capital as it is able to pay off out of its surplus.

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146 [1948] 2 All ER 593 at 606.
147 Ibid.
148 Ibid. at 606-607. See also, Rife Coal Company Ltd [1948] SC 205 where the Court of Session confirmed a reduction of capital even though the procedures for variation of rights and class consent had not been followed.
Chapter 3  

3.3. Mechanics for Reduction (Variation of Rights)

Also, in *Re Scottish Insurance Corporation Ltd*, Viscount Maugham seemed to have followed the views of Lord Greene by asserting that a reduction of capital was not unfair on the grounds that since the preferential shareholders had no right to surplus capital and the company was bound to be wound-up, they could not object to being repaid by means of a reduction the same amount that they would receive upon a proposed liquidation taking place. Lord Simons added:

Funds are available for payment off of capital; the natural order is to pay off that capital which has a priority and I see no glimmer of unfairness in the company doing so at the earliest possible moment particularly if, their undertaking having been wrested from them, they can no longer earn the seven percent or anything like it on their money.\(^{150}\)

A similar point has been decided in Scotland by the Court of Session in *House of Fraser plc, Petitioner.*\(^{151}\) There, a company resolved, by special resolution to reduce its capital by paying off and cancelling the whole of the preference share capital, as being superfluous to its needs. No class meetings of preference shareholders were held to approve or disapprove the reduction. The resolution was passed in a general meeting attended only by ordinary shareholders. Despite the existence of a variation of rights provision and, more particularly, despite the operation of s 125 of the *English Companies Act 1985* to that effect,\(^{152}\) the Inner House confirmed a reduction of the whole of the preference share capital. The rights of the preference shareholders had not been varied or abrogated.\(^{153}\)

\(^{149}\) [1949] AC 462.

\(^{150}\) Ibid. at 463.

\(^{151}\) (1987) 3 BCC 33. On appeal, see, *House of Fraser plc v ACGE Investments Ltd* [1987] AC 387 Co Ltd [1949] AC 462. There, the court confirmed the reduction of the whole of the preference share capital under s 137 of the Company’s Act 1985 (UK). See also, *Re Mackenzie & Co Ltd* [1916] 2 Ch 450. These cases assume that shareholder’ rights are satisfied in a reduction rather than extinguished by repayment. The argument in support further holds that after a reduction, nothing remains of the shares (or part of the shares) to which shareholder rights were attached. Rights were not varied in the usual sense, because that which carried them no longer exists.\(^{152}\)

\(^{152}\) Under s 246C(6), certain issues of preference shares are deemed to be variations of rights for purposes of s 246B, dealing with a company having share capital that is divided into classes. The issues in question are issues of preference shares ranking equally with existing preference shares. Provisions of a company’s constitution governing variation of rights commonly contain an express inclusion of reduction of capital—a provision providing that rights attached to any class of shares shall be deemed to be varied by ‘the reduction of the capital paid up on such shares extended to total repayment and cancellation of preference shares: *Re Northern Engineering Industries plc* [1993] BCLC 1151 per Ferris J.

\(^{153}\) The court applied s 125(3), which lays out specific rules for where a variation or abrogation is connected with a reduction of capital, but which only, applies if rights are varied or abrogated by such a reduction. The court held that they were not.
Chapter 3  
3.3. Mechanics for Reduction (Variation of Rights)

Lord Keith of Kinkel taking the view that the reduction did not affect the rights of preference shareholders, thought fit to quote from Buckley J's judgment in the *Re Salideon* case, including the following passage:

> It has long been recognized that, at least in normal circumstances, where a company’s capital is to be reduced by repaying paid up share capital in the absence of agreement of the sanction of a class meeting to the contrary, that class of capital should first be repaid which would be returned first in a winding up of a company ... The liability to prior repayment on a reduction, corresponding to their right to prior return of capital in a winding up ... is part of the bargain between the shareholders and forms an integral part of the definition or delimitation of the bundle of rights which make up a preference share.\(^{154}\)

Preference shareholders contended inter alia, that the failure to hold class meetings of the preference shareholders was in contravention of their rights under the company’s constitution which provided for such a meeting. They further contended that the reduction of capital constituted a variation of their class rights within the meaning of s 125 of the *Companies Act 1985*, which had not been consented to by the requisite majorities at separate class meetings of preference shareholders. On the preference shareholders’ appeal to the House of Lords, the s 125 point was dropped and the House of Lords only considered whether the actions of the company contravened the variation of rights in the constitution.\(^{155}\) The House dismissed the appeal, on the reasoning that the proposed reduction of preference shares involved the fulfillment and satisfaction of the contractual rights of the shareholders including the return of capital in priority to other shares; and that, since there had been no variation of those rights, there was no necessity to adhere to the consent provision.

\(^{154}\) (1987) 3 BCC 33 at 34. The important point in *House of Fraser* was made by the Court of Session, and the fact that it was dropped before reaching the Lords merely indicates the depth of present perceptions. Further, it might be argued that in *Re Salideon Estate*, the company’s actions did not fall within the objection to variation article that is now s 127 of the 1985 Act, but that they would now fall within the weightier statutory provisions of s 125.
3.3.4.1.2. Moderate Approach.

According to the moderate approach, a reduction of capital which involves the cancellation of shares might involve an abrogation of the rights attached to the shares.\(^{156}\) In *Re Village Roadshow Ltd.*,\(^{157}\) it was held that a resolution to approve a scheme of arrangement under which a company will have the obligation to buy-back or acquire some of its shares, can be considered to involve an abrogation of the rights attached to the relevant shares, especially, where the terms of issue of the shares did not contemplate the company having such an entitlement. The earliest authority in which preference shareholders succeeded in persuading the court not to confirm a proposed reduction which did not adhere to the variation of rights provisions was *Re Old Silkstone Collieries Ltd.*\(^{158}\) In that case, the particular company became subject to s 25 of the *Coal Industry Nationalisation Act* of 1946 pursuant to which the company’s property became vested in the State.\(^{159}\) In view of this provision the company proceeded to reduce its excess capital and in so doing called special meetings of the preference shareholders to approve an interim reduction, as well as asking the ordinary shareholders for their approval. On the final reduction, the directors bypassed this special procedure and called only a general meeting of the company.

The preference shareholders objected to the failure to call a meeting of their class, arguing that the constitution had vested certain rights in them which were being varied by the company without following the variation of rights procedures. The Court of Appeal (Evershed M.R., Jenkins and Morris L.JJ.) went on to discuss the fairness of the

\(^{156}\) *House of Fraser plc v A.C.G.E. Investments Ltd* (1987) 3 BCC 201.


\(^{158}\) (2003) 49 ACSR 167, affirmed in *Village Roadshow v Boswell Film GmbH* (2004) 49 ACSR 27. Also, in *Re Northern Engineering Industries plc* (1994) 2 BCLC 704, a reduction of capital deemed to be a variation of class rights, by the terms on which the shares were issued.

\(^{159}\) [1954] 1 Ch 169. This appears to be one of the early cases where the position of preference shareholders where advantage is taken of a surplus of capital to cancel their shares and thus deprive them of their investment and all their rights against their objections, was first canvassed. A similar approach was taken in *Re Fife Coal Co Ltd* [1948] SC 205. There, the question put before the court was whether class meeting had been correctly held when a company proposed to reduce its capital since it was believed class rights had been varied and the variation of rights procedures which required such consent had not been followed. The court held that the transaction in place was to effect in accordance to the variation of rights and class consent provisions of the prevailing English Companies Act.

\(^{\text{Section 25 of that English Act which originally believed to have conferred rights of some value upon the holders of preference shares.}}\)
reduction and held that the procedure for the reduction of capital had created a ‘right’ in
the preference shareholders which was attached to each preference share under the terms
of the variation of rights provisions. As the effect of the resolution to reduce capital was
to vary that right, the company was bound to follow the requirements of the variation of
rights procedures. They also held that the scheme was not a just and equitable one.160

The above decision illustrates that the court may still apply class rights provisions in
deciding whether the reduction is being performed equitably. For it is likely that, in order
to be equitable when there are different classes of share in a company, the reduction must
be in conformity with the rights of the various classes in a winding-up. The company
must avoid extinguishing any prospective rights such as an express right to exercise any
future rights that may be given to shareholders under government regulations.
Accordingly, the s 25 proviso above was held to prevent the passing of a subsequent
resolution to repay to preference stockholders the whole of their paid-up capital. It
attached special rights to the preference shares which were protected by the variation of
rights article and which would be abrogated by the extinction of the stock.

Another decision of similar purport which helps to undermine a possible interpretation of
*Re Saltean* and *House of Frasers*, is *Re Northern Engineering Industries plc.*161 There,
the company’s constitution provided that the rights attached to any class of shares should
be deemed to be varied by the reduction of capital paid up on such shares. A company
proposed to reduce its capital by paying off the preference shares and cancelling them
without following the requirements for a variation of rights. The company argued that it
did not have to obtain the class consent to the reduction since the provision making a

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160 While the court considered that the total elimination of the preference shares without the variation of rights
procedures would tantamount to a variation of preferential shareholder rights and therefore prejudicial to their
interest, Jenkins L.J went a little further, by spelling out that the proper procedures were to avail by saying: “In
order therefore, validly to carry out this reduction it was necessary to hold a general meeting to which would be
summoned not only the holders of the ordinary stock and second participating preference stock, but also the
holders of the first preference share, and in addition, it was necessary to put the proposals to separate meetings of
the holders of those two classes of shares in accordance with the procedures in its constitution and, procure the
respective approval of those two classes of shareholders to the proposal”. A further support for this view was in
Chapter 3  3.3. Mechanics for Reduction (Variation of Rights)

reduction a variation of class rights did not apply since it only applied to a reduction to a figure which was in excess of zero. Ferris J held that the effect of art 7(B) in the company’s constitution was to make the proposed reduction and cancellation a variation of the class rights of the shareholders for which consent of the classes of preference shareholders was required.

More interestingly, it would be prudent to also have recourse to the Court of Sessions decision in *Frazer Brothers, Petitioners*.\(^\text{162}\) There, the proposed scheme for the reduction of capital involved the return of the whole of the preference capital but had been approved by the separate class meeting. But the reporter to whom the petition for confirmation had been remitted queried the necessity of such a class meeting. Lord President Clyde in expressing the view that the holding of the meeting had been necessary to the validity of the reduction of capital in that it involved the abolition of the rights of the preference shareholders said:

The reporter has raised the question whether a separate meeting of preference shareholders was required, upon the view that the proposal was not a variation of the rights of preferential shareholders, but an abolition of these rights. The purpose of requiring a separate meeting of a class of shareholders where a reduction of capital involves an alteration of their rights is to ensure that their legitimate interests are not swamped by the votes of other members of the company in general meeting. A fortiori, where their rights are not merely altered but are being wholly abolished, this protection of a separate class meeting is all the more necessary. This conclusion is confirmed by the provisions of subs (6) of s 72 of the *Companies Act 1948* ... whereby it is provided that the expression ‘variation’ in this connection includes abrogation and the expression ‘varied’ is to be construed accordingly. In our opinion, therefore, the separate meeting of preference shareholders was correctly held.\(^\text{163}\)

Whatever the reconceptualisation of the law regarding a return of capital and the variation of rights entails, it is clear that the courts have not developed a satisfactory general principle of law. However, a clear balance of authority supports the proposition that a reduction of preference capital effected under a statutory power does not vary or

\(^{161}\) [1994] 2 BCLC 704. (Though obviously distinguishable from *House of Fraser*). It followed from *Re MB Group plc* [1989] BCLC 672 and *Braiton Seymour Services Co Ltd v Oxborough* [1992] BCLC 693

\(^{162}\) [1963] SC 139.
abrogate the rights of the preference shareholders unless the rights attached to the preference shares say otherwise. While a reduction of capital might vary the rights of preference shareholders to some extent, certain re-rationalisation and restatement would be valuable:

- A cancellation of preference shares on a reduction of capital, effected under a power conferred by a company’s constitution, does not vary the rights attached to the shares unless their class rights indicate otherwise.\textsuperscript{164} However, a cancellation of shares can, in some circumstances, be said to abrogate the rights of shareholders for the purposes of a variation of class rights provisions.\textsuperscript{165}

- The view that indirect alterations affect the enjoyment of rights but not the rights themselves,\textsuperscript{166} does not work. You cannot alter a right without affecting its enjoyment, and cannot alter the enjoyment without affecting the right.\textsuperscript{167}

- The practical effect of s 256C(2)(b) for example, is to treat a capital reduction involving the cancellation of shares other than pursuant to an equal reduction, as being equivalent to a variation of the rights of the holders of the shares to be cancelled. Where there is a variation of rights, s 246D can be invoked which allows members holding at least 10 percent of the votes of the relevant class to seek to have the special resolution set aside by the court.\textsuperscript{168}

- The rationale of the s 256C(2) procedure may not be very consistent with the common law position but, it provides a channel by which minority shareholders could be protected otherwise, recourse can still be had from the s 232 oppression remedy provisions.

- Class rights amount to the constitutional status of a class of shares, and any alteration in this status involves the variation of the rights of the class concerned.

- It should correspondingly be acknowledged that there is no variation or abrogation where there is no change in constitutional status.

- Where class rights are narrowly defined, the position of investors could only be properly protected by the existence of articles that specifically required investor consent to vary their constitutional status\textsuperscript{169} or perhaps by contract to similar effect.\textsuperscript{170}

\textsuperscript{163} Ibid. at 140. Cf. also, s 256C(2) and the following cases; \textit{Re Allgas Energy Ltd} (1998) 27 ACSR 729; \textit{Village Roadshow Ltd v Boswell Film} [2004] VSCA 16

\textsuperscript{164} \textit{Re Daniel Clifford Investments Ltd} [1948] SASR 278 at 280 per Napier CJ; \textit{Re Saltdean Estate Co Ltd} [1968] 1 WLR 1844 per Buckley J; \textit{House of Fraser plc v ACGE Investments Ltd} [1987].

\textsuperscript{165} \textit{Re Allgas Energy Ltd} [1999] 1 Qd R 294 per Thomas J; \textit{Village Roadshow}, above n 144 per Mandie J.

\textsuperscript{166} Per Evershed M.R. in \textit{White v Bristol Aeroplane Co Ltd} [1953] 1 Ch 65 at 74.

\textsuperscript{167} \textit{See, Lord St Davids v Union Castle Mail Steamship Co Ltd} (1934) 76 Sol Jo 877, which recognized that an alteration in the voting rights of one class affects the voting rights of another.

\textsuperscript{168} The problem in the application of s 246D relates to the question of whether will it be all members who must unanimously agree to set aside the resolution or, is it just a fraction of those with 10%?

\textsuperscript{169} Though there might be no authority for such a distinction, there is no authority against it.

\textsuperscript{170} For example, see, \textit{House of Fraser plc v ACGE Investments Ltd} (1987) 3 BCC 201 at 204.
The cases which looked at the meaning of various wordings of variation of rights clauses were mainly decided on points of construction, and should be of secondary importance to the overall coherent application of either s 246 or its English equivalent, s 125.

It might be objected that the approach advocated here, in emphasizing the preservation of corporate constitutional status, places unacceptable fetters on a company and paralyses its business.\(^{171}\) It heightens the danger of one class gaining exorbitant bargaining power and controlling the company.

The mere fact of a wish for a reduction of capital should not itself attract the necessity for class consents.\(^{172}\) This can easily overcome the perennial dangers of irredeemable deadlock, a minority bringing a company to its knees and the non-correlation of assets with capital. Capital reduction is the best way to prevent these problems since shareholders are left free to invest elsewhere if they wish. This is consistent with the proposed principle since there are significant differences between capital reduction and other alterations in status. First, shareholders’ rights are satisfied (rather than extinguished) by repayment. Second, after a reduction, nothing remains of the shares (or part of the shares) to which the rights were attached. Rights were not varied or abrogated in the usual sense. Because that which carried them no longer exists.\(^{173}\) Third, safeguards are provided by both s 256B (1) (a) and s 256C (2) in cases of reduction since they ensure that all shareholders are treated fairly and reasonably. The test is of similar effect to the protection of rights provisions—consideration of fairness involves expectations, which often manifest themselves as rights. The courts and ASIC may still of course apply class rights provisions in deciding whether the reduction is being performed equitably.

### 3.4. Protection of Creditors and Shareholders under a Reduction of Capital

The capital reduction rules are designed to protect the interests of both creditors and shareholders by addressing the risk a reduction could lead to the company’s insolvency.\(^{174}\) It also seeks to ensure fairness between the company’s shareholders.\(^{175}\)

\(^{171}\) *Cf. Andrews v Gs Meier Company* [1897] 1 Ch 361 at 371; *White v Bristol Aeroplane Co Ltd* [1953] 1 Ch 65 at 80.

\(^{172}\) This may of course be contradicted by the company’s articles, as in *Re Northern Engineering Industries plc* [1994] 2 BCLC 704.

\(^{173}\) This reasoning was used by the inner House of the Court of Session in *House of Fraser plc, Petitioner* (1987) 3 BCC 33 and also, *obiter*, in the House of Lords on appeal: *House of Fraser plc v ACGE Investments Ltd.* (1987) 3 BCC 201.

\(^{174}\) *Corporations Act 2001* (Cth), s 256A(a).
3.4. Protection of Creditors

3.4.1. Creditor Protection.

Traditionally, under the common law, the interests of creditors in relation to a reduction were paramount. The courts would normally require a company to publicize the reasons for the reduction and, to advertise it in the official gazette or local newspapers so that creditors could come forward and object to a proposal. The court would also, settle a lists of creditors and inquire whether they have consented and if not, whether they were adequately protected.\(^{176}\)

Creditors’ protection under current law is addressed differently. In accordance with s 256B (1) (b), a company can only reduce its share capital if it does not materially prejudice the company’s ability to pay its creditors. Though this provision does not expressly indicate a solvency requirement, it is taken to reflect solvency in relation to section 256E (wherein, item I, s 588G) relates to the liability of directors on insolvency. If this interpretation is the correct one, then s 256B (1) (b) may be construed to mean that a company can only reduce its capital if it is able to meet the cash-flow solvency test—that is, if after the reduction, it is able to pay its debts as they fall due. According to section 95A and the authority in *Sandell v Porter*\(^{177}\), insolvency is expressed as inability to pay debts as they fall due.

This is consistent with s 588G (1A) which states when a debt is incurred for purposes of the insolvent trading provisions and requires that before the directors make any return to shareholders, they must consider whether the company is able to pay its debts as they become due and payable.\(^{178}\) For the purpose of s 588G, a company is taken to incur a debt when a share capital reduction (other than one involving the cancellation of shares

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\(^{175}\) Ibid. s 256A(b).


\(^{177}\) (1966)115CLR 660. A comprehensive analysis of the solvency requirement, for purposes of all transactions affecting share capital is provided in Chapter 8 of this study. As indicated in chapter 8, under Australian law, proof that a company’s debts has not been paid, standing alone, does not establish insolvency. Section 95A requires ascertainment of the company’s existing debts, its debts within the near future, the date each will be due for payment, the company’s present and expected cash resources.

\(^{178}\) A director would therefore contravene s 588G if the company was then insolvent, or became insolvent as a consequence of the reduction and the director was aware at that time that there were reasonable grounds for so suspecting. ASIC may be persuaded to take proceedings against directors who make any payments in the form of a reduction of capital without satisfying the s 588G duty. Directors are personally held liable in breach of a civil penalty order under s 1317(G-H) and Pt 9.4B and are made to compensate the company if the company is, or becomes insolvent when the company reduces its capital. They may also be liable for a criminal offence where dishonesty or fraud is proven. (An elaborate understanding can be found in Chapter 8 below).
for no consideration) takes effect. Though the law does not provide any consultation process in regards to a proposed reduction, the company is compelled to inform ASIC at least 14 days (35 days in cases of selective reduction) before a reduction is effected.\textsuperscript{179} It is assumed, the Australian Securities and Investment Commission, will make the relevant information of the proposed reduction available to creditors and the public by entering the information on its Alert System, to which creditors may subscribe. Those creditors who become aware of a proposed reduction either through the system or otherwise, may complain to ‘ASIC’ which may take proceedings to restrain a company under s 1324 from contravening s 256B. Under s 1324, relief can be sought by any person whose interest would be affected by the breach of s 256B.\textsuperscript{180}

The current law thus provides a mechanism for the protection of creditors. However, it is couched with some difficulties. Firstly, there are terminological problems. It is unclear what precisely is meant by ‘material prejudice’. The Explanatory Memorandum,\textsuperscript{181} suggests that whether prejudice is material is a question of judgment to be determined in the light of all relevant circumstances, including the particular characteristics of the company and the situation of the company’s creditors. Therefore, a reduction might prejudice the company’s ability to pay one or more of its creditors even though it might not necessarily lead to the company’s insolvency. If this is the right interpretation, does it mean ‘prejudice to creditors’ can be equated with risk of insolvency? It has also been questioned whether material prejudice to the company’s ability to pay its creditors means that payment of all (as distinct from one or more) creditors must be prejudiced.\textsuperscript{182} Though neither the Corporations Act or the Explanatory Memorandum adequately provides answers to the above questions, it is suggested that if solvency is the litmus test for creditor’s safety, then effective creditor protection should rely on the interests of individual creditors since creditors are heterogeneous in character and their risks of contagion are diverse.

\textsuperscript{179} Ibid. s 256C (3).
\textsuperscript{180} Creditors also have standing to apply to the Takeover Panels under s 657C (2)(d) on the ground that a reduction would constitute ‘unacceptable circumstances’.
The lack of a creditor consultation process in a proposed reduction of capital process may adversely affect their interests. The mechanism for information dissemination through the ASIC Alert System is, arguably, not a reliable means of creditor protection. What will happen to those creditors who do not subscribe to the system even if it is free of cost? Creditors not subscribed to the system may not be aware of a company’s activities, for example, they might be ignorant that a company was proposing to reduce its capital. They might only be aware perhaps after the reduction has taken place and it would be too late for them to take any action to prevent a reduction that has already been effected. It is not clear how creditors could then be protected under such situations.\textsuperscript{183} Though they might be protected from the compensation received from directors who return capital when the company was insolvent and unable to pay its debts, the situation may be different where the reduction has already taken place and, the company is liquidated as a result but, the director(s) are also declared bankrupt with no resources at their disposal to pay the debts of the creditors.

A possible remedy to such situations would be to evoke the common law position whereby, reasons of any proposed reduction are made public in national gazettes and local newspapers, with creditors given the right to object to a reduction before its goes into effect. Creditors might also require security for the amount of their debts. They can also evoke s 1324 with ASIC to restrain the proposed reduction taking effect. While the requirement of a solvency test is an appropriate approach in determining the viability of a company and its ability to pay its debts, it is doubtful if reliance only on the cash flow solvency and on the insolvent trading provisions are adequate.\textsuperscript{184} The possible suggestion would be that a dual and cumulative cash flow and balance sheet solvency, reinforced by s 588G, may afford a reasonable means of protection to creditors.\textsuperscript{185}

\textsuperscript{183} Cf section 588G.
\textsuperscript{184} As earlier indicated in Chapter 2 (buy-back) and as will be seen in Chapter 8, reliance on only one limb of the solvency test may not be a reliable means of regulating share capital transactions. Also, my discussion of the insolvent trading provisions in Chapter 8 suggest that, s 588G adequately protects unsecured creditors but not secured creditors who have various contractual means to protect themselves.
3.4.2. Shareholder Protection.
The new share capital reduction rules in s 256B(1) (a & c) inclusive, seek to ensure that a company may only reduce its capital in a way that is not otherwise authorized by law if the reduction is fair and reasonable to the company’s shareholders as a whole and, is approved by shareholders under section 256C. The type of shareholder protection contemplated here is focused on the protection that the law affords to minority shareholders, since they are the members of a class whose shares are cancelled as a result of a share capital reduction and are also those who are easily eliminated from the company through a selective capital reduction.\textsuperscript{186}

3.4.2.1. Protection from the Special Resolutions & Disclosure Procedures.
A company uses s 256C(2) to cancel all of the shares in its share capital except those held by one shareholder. It is possible for only some of the shares in a class to be cancelled.\textsuperscript{187}
This will leave the shareholder with 100 percent control of the company. For convenience, this shareholder(s) is called a ‘majority shareholder’, and those whose shares will be cancelled the ‘minority shareholders’ as it would usually be the case that the shareholder whose shares are not cancelled would have held most of the shares in the company prior to the reduction of capital.

\textsuperscript{186} It is important that this part of creditor protection should be read in conjunction with chapter 8 below, where various safeguards for creditor protection are advanted.

\textsuperscript{187} Minority shareholders in this context will refer mostly to those preference shareholders who as a result of a selective reduction of capital, they are being eliminated from the company either through a cancellation of their shares or a variation of their rights and thereby, ceasing to be members of the company. While a selective reduction of capital and the procedures it affords minority shareholders under s 256C remains the point of focus in this study, it is to be noted that it is only one of the ways in which minority shareholding may be eliminated from the company and, a majority shareholder is by no means confined to these provisions in seeking to ‘freezout’ the minority. There are other alternative ways of eliminating such minorities which include: a members’ scheme of arrangement embodying a selective reduction of capital; and a compulsory acquisition under the Corporations Act. For a detailed analysis on the law concerning eliminating minority shareholders generally and the various alternative techniques of eliminating minority holdings see, Q. Dighy, “Eliminating Minority Shareholdings” (1992) 10 C&SLJ 105-124. Consider also the following: Alberto Colla, “Eliminating Minority Shareholdings-Recent Developments” (2001) 19 C & SLJ 7; G. Hughes, “Compulsory Acquisition of Minority Shareholders’ Interest-Still a Tyranny of the Majority?” (2000) 18 C&SLJ 197; E. Boros, “Compulsory Acquisition of Minority Shareholdings-The Way Forward?” (1998) 16 C &SLJ 279; P. Spender, “Compulsory Acquisition of Minority Shareholdings” (1993) 11 C&SLJ 83. Consider also the following: Murray, Pickering, “The Problem of the Preference Share” (1963) 26 MLR 499; J. Gold, “Preference Shareholders in the Reconstruction of English Companies” (1943-44) 5 U To LJ 282.
Chapter 3

3.4. Protection of Shareholders

For the purposes of a selective reduction of capital and the elimination of minority shareholding, section 256C (2) provides that if a reduction is a selective reduction, it must be approved by either:

(a) a special resolution passed at a general meeting of the company, with no votes being cast in favour of the resolution by any person who is to receive consideration as part of the reduction or whose liability to pay amounts unpaid on shares is to be reduced, or by their associates; or

(b) a resolution agreed to, at a general meeting, by all ordinary shareholders. Where the reduction involves a cancellation of shares, a second special resolution of the shareholders whose shares are to be cancelled is also required. This resolution should be passed at a separate meeting of those shareholders.

3.4.2.1.1. Application of s 256C(2)(a)

An interpretation of the above proviso was considered in *Re Tiger Investments Co Ltd*. The case involved a proposal for a selective reduction of capital intended to eliminate the minority shareholding by the cancellation of their shares through a members’ scheme of arrangement under s 411(1) which permitted the company to convene a meeting of its shareholders to approve the members’ scheme. Accordingly, the procedures under s 256C(2)(a) were invoked by those shareholders who were to be eliminated from the company by requiring those members who were to receive consideration as part of the reduction not to cast any votes in favour of the resolution. A conflict arose between members in the interpretation and application of some of the wording in the section. These included, the meaning of phrases such as; ‘receive consideration as part of the reduction’ and, “no votes being cast in favour”. Santow J said:

Section 256C(2) (a) seeks to exclude shareholders who will receive consideration as part of the reduction (or whose liability to pay amounts on unpaid shares will not be reduced) or their associates from a consideration of the special resolution to approve the selective reduction. The logic of this exclusion is clear. The remaining shareholders could be disadvantaged if the capital

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187 *Re Hunter Resources Ltd* (1992) 7 ACSR 436 at 440; *British & American Trustee & Finance Corp Ltd v Cooper* [1894] AC 399 at 403.

188 The role of a selective capital reduction according to *Re Tiger Investments Co Ltd* (2000) 18 ACLC 62 SC (NSW), is employed to achieve one of the following objectives: (i) to eliminate minority shareholders whereby they may be eliminated by the cancellation of their shares on a loss reduction and, (ii) to allow a shareholder to exit its investments typically in a proprietary company where there is no liquid market for the shares to realize its investment.
reduction were too generous. The exclusion ensures that the resolution is not passed by reason of the influence of shareholders that stand to benefit from the capital reduction.\footnote{190}

Where the consideration for a selective reduction is to be provided by a third party, rather than the company, it is questionable whether the shareholders who are to receive the consideration should be precluded from voting in favour of the resolution and, whether it can be construed to mean a consideration moving from the company or from a third party in which the reduction of capital was to occur. Santow J reasoned that if a selective reduction was combined with an independent members’ scheme under which a third party will be issuing shares to the existing shareholders, by implication, the existing shareholders are not receiving consideration ‘as part of the reduction’.

His Honour intimated that such consideration (the shares) emanate from the third party and are therefore, tied to the members’ scheme. Whether this is a fair reading of the section is doubtful. It can be argued that a scheme of arrangement which is independent of a selective reduction of capital can be used to sidestep the safeguards afforded by s 256C(2). This is so in the sense that, schemes of this nature typically involve the suitor company offering cash and / or shares to security holders of the scheme company whose securities are to be cancelled. In such a situation, the compensation for the selective reduction in the scheme company’s capital arguably, is emanating from someone other than the scheme company.\footnote{191}

As to the question whether shareholders receiving consideration should be precluded from voting in favour of the resolution, in \textit{Re Tiger Investment Co Ltd},\footnote{192} the court considered that there was merit in the argument that the shareholders should be allowed to vote in favour because the reduction involves no liberation of the company’s assets and therefore, no risk that it is too generous to one class of shareholders over the others. This cannot be taken to be the correct interpretation because it would be inconsistent with

\textit{CtRe Etrade Australia Ltd} (1999) 17 ACLC 695. Though this was an equal reduction, the consideration to shareholders whose shares were proposed to be reduced, it was held the consideration did not move from the company to which the capital reduction relates, but from a third party.
the legislation. Section 256C(2)(a) precludes those shareholders receiving consideration from casting their votes in favour of the resolution since it would give them an undue influence over those shareholders whose shares are to be cancelled.

Furthermore, if shareholders receiving consideration can vote in favour of a resolution then, who are those shareholders who cannot vote in favour? Does this imply that all shareholders have a choice to either vote for or against a resolution if they want to? In Village Road Show Ltd v Boswell Film GmbH a similar question of 'vote casting' was raised concerning s 257D(1)(a). It was argued by ASIC that s 257D prevented preference and ordinary shareholders ('excluded holders') from voting in favour of the buy-back resolution but did not prevent them from voting against it.

Mandic, J held that such combined shareholders were entitled to vote against the buy-back resolution in respect of their ordinary shares and that s 257D did not prevent preference shareholders, or combined shareholders in respect of their preference shares from voting against the resolution. A similar view by Callaway J.A on appeal was that if preference shareholders are entitled to vote on a proposal to reduce ordinary (or preference) shares, what possible difference would it make that the mechanism is a share buy-back. It can be argued that where shareholders have voting rights prescribed by the Corporations Act or the company's constitution, they must be exercised in accordance with the conditions prescribed. If the powers enshrined in their rights openly give them the freedom to vote for or against a special resolution, one sees no objection why they cannot exercise that right in favour or against a resolution to cancel their shares. But, whereas under s 256C(2)(a) the law expressly prohibits those shareholders receiving consideration not to vote in favour of the resolution, that should be the correct interpretation of the law. This is also consistent to a

194 It is important to note that both s 256C (2) (a) (redemption of capital) and, s 257D (1) (a) (buy-back, are similarly worded, to attain the same goal (taking away from interested shareholders the power to vote in favour of a resolution which apparently benefits them). The scheme booklet and the notice of general meeting under the s 257D regime, were drafted in the belief that, by reason of s 257D, members of the company who held both ordinary shares and preference shares were not entitled to vote on the resolution required by the section, even in the respect of their ordinary shares.
similar approach to the drafting of shareholder protection procedures under the ASX Listing Rules. For example, the Standard Voting Exclusion Statement contained in Listing Rule 14.11 make it clear that the entity seeking shareholder approval, must only disregard any votes cast on a resolution by the (named) person (or class of persons) excluded from voting and an associate of that person.

Another questionable interpretation of s 256C(2)(a) relates to whether the mere fact that a person has, contrary to s 256C(2)(a), cast a vote in favour of a selective reduction, is adequate to invalidate the relevant resolution. In Re Tiger Investment, Santow J initially, held that the resolution should only be invalid if the improperly cast vote was not excluded or disregarded when determining the result of the vote. However, in Winpar Holdings Ltd v Goldfields Kalgoorlie Ltd, the New South Wales Court of Appeal held a reduction effected in contravention of s 256C will be valid because of the terms of s 256D (2) (a-b). Although it was previously indicated above that in interpreting s 256C(2)(a), it would be important that the language of the statute be given its ‘direct application’ however, it is difficult to accept the court of Appeals decision in Winpar Holdings to have correctly stated the law. Even if the decision is consistent with s 256D(2) it would now be more important to ascertain the policy objective of the shareholder approval provisions and the effect which a selective reduction of capital might have on minority shareholders whose shares are to be cancelled.

Given the injunction relief provided by s 1324 (1), against a contravention of the law, it would be more reasonable to adopt the views of Santow J in Re Tiger Investment than that under Winpar Holdings. The effect is that by evoking s 1324 relief prior to the reduction occurring, s 256D (2) becomes inapplicable. To accept that it applies would be.

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195 See also, ASX LR’s 3K (5) and rule 6.3.
196 In Re Etrade Australia Ltd (1999) 17 ACLC 695, Santow J observed that the special resolution procedures give rise to the absurdity that in practical terms the necessary resolution could not be passed unless unanimity, inviting corporate blackmail. Because, s 256C(2)(a) requires those shareholders to whom a selective capital reduction is directed not to cast their votes in favour of the resolution, since they would have been paid consideration as part of the reduction. (This view of Santow J is only relevant where all shareholders are disenfranchised from voting on the first special resolution—that is, where they are all to receive some consideration).
197 (2002) 20 ACLC 265
to render the protection afforded to minority shareholders under s 256C (2) and s 1324 attenuated. The writer’s view point is consistent to that of the ASX Listing Rule 14.11 which requires that, if members improperly vote on a resolution to approve a selective reduction, it would seem that the requirements of s 256C(2)(a) would not be met even though the resolution would have been passed had the improper votes been excluded. 199

3.4.2.1.2. Procedure under s 256C (2)(b).

Since it is apparent that under s 256C (2)(a), all shareholders and their associates are prevented from voting in favour of a special resolution, where therefore, a proposed reduction involves cash being paid to all shareholders, but the terms are not the same for all members, such a reduction would have to be unanimously approved by all ordinary shareholders under s 256C(2)(b). It is apparent there might be certain difficulties and problems in giving meaning to this first part of the section. Arguably, it is not clear what the section means by ‘ordinary shareholders’.

Does this imply that approval under this section involves all ordinary shareholders attending the meeting and voting in favour of the resolution or, all of ordinary shareholders who choose to attend and vote at the general meeting, in person or by proxy, in favour of the resolution? Or, does it mean those ordinary shareholders in attendance in person or by proxy and not casting their votes against the resolution? 200 Like a similarly worded s 257D(1), in Re Tiger Investment, 201 Santow J thought that the reference to all ordinary shareholders presumably meant those ordinary shareholders who are present in person or by proxy, and who vote at the general meeting. But, in Re Etrade Australia, 202 the same judge said that ‘unanimity of all ordinary shareholders at the meeting was required’. His Honour however, observed that such type of resolution procedure, gives rise to the absurdity that in practical terms

199 Section 256D (2) states that if the company contravenes subsection (1); (a) the contravention does not affect the validity of the reduction or of any contract or transaction connected with it; and (b) the company is not guilty of an offence.

199 Contra, Re Tiger Investment Co Ltd (2000) 18 ACLR 62 at 68 where Santow J thought there is some merit in the argument that the provisions in the Corporations Act were not intended to operate in the same way as the ASX Listing Rules.

200 This argument is consistent to that of J. Hambrook, above n 182 at para 2.6.0270.


invites corporate blackmail. In *Winpar Holdings*, at the New South Wales Court of Appeal level, it was suggested that the second part of s 256C (2) (b) contemplates a meeting in which only those shareholders whose shares are to be cancelled are to be present. Under s 256C(2)(b), if a selective reduction involves a cancellation of shares, it must also be approved by a special resolution passed at a meeting of the holders of those shares. Previously, under the former law, if a company wanted to cancel a class of preference shares, it could do so by special resolution of a general meeting. The preference shareholders could only vote on that resolution if their voting rights allowed them to do so. The cancellation did not also have to be approved by the preference shareholders as a class unless their class rights provided otherwise.

Certain questionable issues may be apparent in giving effect to this part of section 256C (2)(b) concerning the cancellation of shares and the second special resolution requirement. Does the section contemplate that in a special resolution meeting where shares are to be cancelled on a selective reduction of capital, other members can attend the meeting without voting or actively participating? In *Re Tiger Investment Co Ltd*, Santow J took the view that the section merely contemplates a meeting in which only those shareholders whose shares are to be cancelled are present. But in *Winpar Holdings Ltd*, his Honour made an about face, by suggesting that it was not necessary to close the gates of the meeting to other persons, provided that “the extraneous persons do not themselves vote (save as proxy holders) or attempt improperly to influence the outcome of the meeting”.

In *Winpar Holdings*, the company purported to satisfy all the requirements of s 256C(2) at a single extraordinary general meeting. No separate meeting of the shareholders whose shares were to be cancelled was convened. Santow J held that a separate meeting was

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205 Because the concept of ‘class’ is defined very widely, and various shareholders in a class have slightly different interests, would it mean according to the second part of s 256C(2)(b) that a single second special resolution should be convened, or, because shareholders in a class have different interests, separate special resolutions should be held? The legislature is silent on this point. Cf. *Re Robert Stephen Holdings Ltd* [1968] All ER 195 where Plowman J, approved a reduction of capital where all the ordinary shares other than those held by the
not required but that, in any event, orders could if necessary, be made under s 1322(4) to validate what was done. On appeal, it was held that s 256C (2) required the company to convene and hold a separate meeting of the shareholders whose shares were to be cancelled. Accordingly, Santow J’s decision is incorrect. Firstly, elimination of minority shareholdings under a selective reduction of capital resulting in the cancellation of their shares requires the convening of a second special resolution of that particular class of shareholders under s 256C(2)(b). The question is not whether the second resolution is to be attended by all members of that class. The issue is, was there a second resolution? If the answer is in the negative, then the views of Giles and Beazley JJA that the failure to hold the separate meetings was a `procedural and substantive irregularity for purposes of s 1322 (2) is the rightful decision.

Secondly, Santow J is wrong to have reasoned that orders could be made under s 1322(4) to validate what was done. This would be inconsistent with s 256D (2), which provides that the failure to convene and hold a separate meeting did not affect the validity of the capital reduction. By implication, therefore, s 1322(4) is irrelevant because it does not have any force of strength to remedy the situation in favour of members of a class. The best guess would be to follow the New South Wales Court of Appeal decision in Winpar Holdings,206 which intimated that an injunction under s 1324 could have been sought to restrain the reduction at any time before it was made. But once it was made, s 256D governed the consequences of the contravention of s 256C (2).

3.4.2.1.3. Enhanced Disclosure Procedure.

Under the Corporations Law, before a proposed reduction was to be confirmed by the court, it would make sure that the reasons and effect of the proposed reduction were made public, by advertising the reasons, causes and consequences of the reduction in the official Gazette and local newspapers. ASIC Policy Note 29, sets out more detailed disclosure requirements. They have recommended that in a proposal for a reduction of majority shareholder were cancelled. However, he said; “It is desirable in cases like the present to proceed by way of a scheme of arrangement for ... the interests of minority shareholders are better protected under a scheme”.

capital, companies must disclose all facts and information reasonably necessary to enable shareholders to make an informed decision on how to vote; a reasonable description of what is actually proposed to be done and all (not just some) of the material reasons for that proposal, and any information required under the disclosure regimes in Ch 6 and Part 5.1 that is relevant to the capital reduction.\textsuperscript{207} The \textit{Corporations Act}, s 256C (4) & (5), makes provision for disclosure somewhat different from that of the old law. They state that the company must include with the notice of the meeting a statement setting out all information known to the company that is material to the decision on how to vote on the resolution. However, the company does not have to disclose information if it would be unreasonable to require the company to do so because the company had previously disclosed the information to its shareholders.\textsuperscript{208}

While the legislature and ASIC seek to make sure adequate disclosure is provided by the company to its members, a literal construction of the disclosure provision if viewed in a similar context of a disclosure of information in voting proceedings can trigger an unbalanced presentation or intentional obfuscation of information with the effect that, shareholders as a whole will be prevented from providing an informed judgment. Firstly, it is unclear in s 256C (4), when information may be ‘reasonable and unreasonable.’ The Explanatory Memorandum provides that, in determining whether it would be unreasonable to require disclosure involves a consideration of the circumstances and context of the prior disclosure. The relative importance of the disclosed information should also be relevant. According to the Explanatory Memorandum, a company that had previously disclosed material information in its last annual report may need to include the information in its disclosure statement if its relevance to the capital reduction would not be apparent to shareholders.\textsuperscript{209} Although the provision cannot be more specific, an examination of some cases goes to show that the disclosure provision under the reduction

\textsuperscript{207} ASIC PN 29 (1990) at PN 29.20. This approach was applied in, \textit{Re Prime Holdings Ltd} (1994) 12 ACLC 308 at 313; \textit{Phosphate Co-operative of Australia Ltd v Douglas Steven Shears} (1998) 14 ACLR 698. This is a commendable approach however, it is not a legislative mandate that must be followed.

\textsuperscript{208} Section 256C (4). Section 256C (5) requires the documents to be lodged with ASIC. Within 14 days of a resolution being passed, the company must lodge a copy of it with ASIC (s 256C (3)). To allow ASIC a reasonable time to consider its position in regard to the proposed reduction, the reduction must not take place until 14 days after the copy of the resolution was lodged (s 256C(3)).

of capital regime is not an effective model. The drafters of s 256C (4) failed to have regard to the decision arrived at in *Phosphate Co-operative of Australia Ltd v Shears (No 3)*,\(^{210}\) where in a scheme of arrangement involving a reduction of capital, the court opined that all information and any other information that was material to shareholders and affected creditors need to be disclosed so as to enable those parties to accept or refuse a proposed scheme of arrangement or takeover scheme.\(^{211}\) Generally, an adequate disclosure of material information in a special resolution should be an important consideration for both ASIC and the courts to enable them arrive at a conclusion as to whether a resolution passed for a return of capital selectively treats the various parties fairly and reasonably. This is consistent with the decision arrived at in *Re Campaigns Holdings Pty Ltd*\(^{212}\) where the court refused to confirm a reduction of capital by the cancellation of preference shares where a meeting of those preference shareholders had been adjourned to enable them to consider any new information which has come to light thereby, enabling them to make an informed decision during the voting process.

Also, the method of disclosure by Thomas J’s dictum in *Re Crusader Ltd*\(^{213}\), can be used in providing considerable guidance. There, he gave some guidance as to how the court will assess whether information disclosed in an explanatory statement is adequate. His Honour, citing *Fraser v NRMA Holdings Ltd*\(^{214}\), indicated that the obligation to furnish a comprehensive explanatory statement for purposes of a scheme, must be balanced by the need to present an understandable document which is likely to assist rather than to confuse, and that the adequacy of the information provided should be assessed in a

\(^{210}\) (1988) 6 ALC 1,046.

\(^{211}\) *Phosphate Co-operative Co of Australia Ltd v Shears (No 3)* (1988) 6 ALC 1,046. The test for disclosure under a schemes of arrangement or a take over schemes it is argued, should be equally relevant and be applied similarly to a selective capital reduction procedures if they are intended to provide protection to those minority shareholders whose shares are to be cancelled. The suggestion for adopting the scheme disclosure procedures is consistent also with the disclosure principles enunciated by ASIC in its draft policy statement, “Schemes of Arrangement and ASC Review” (issued 13 October 1997)para 16, where it intimated that it will object to a proposed scheme of arrangement which involves shareholders of the scheme company receiving shares in another company, if the information disclosed in the explanatory statement is not the type and standard that the shareholders of the scheme company would receive in comparable situations. This congruency of disclosure was confirmed in *Re Archaen Gold NL* (1997) 23 ACSR 143 at 145 in which Santow J stated that, where what is being done under a scheme of arrangement is substantially equivalent to a conventional takeover, shareholders should not be deprived of equivalent information, even if that information is not specifically required by the provisions governing disclosure.

\(^{212}\) (1989) 15 ACLR 762; (1990) 8 ALCR 64 at 69

\(^{213}\) (1995) 13 ALC 1,008
practical way, having regard to the complexity of the proposal. It is therefore submitted that to address the problem of information asymmetry in a reduction of capital that could give all parties the chance to make an informed decision on whether to vote or not, on a resolution, that part of the s 256C(4) disclosure provision which provides that a company need not disclose information because it considers it unreasonable or, because such information was already disclosed previously to shareholders can be redrafted by adopting the guidance for a comprehensive disclosure taken in the Fraser case.\(^\text{215}\) It is suggested that the s 256C(4) disclosure proviso will be weakened by the variation of minimum levels of required disclosures under alternative procedures of the Corporations Act.\(^\text{216}\)

3.4.2.2. Protection from the ‘Fairness’ Procedure.

Broadly speaking, the judiciary and legislature have developed various considerations in determining whether a transaction affecting share capital is ‘fair and equitable’ or ‘fair and reasonable’\(^\text{217}\) to the various corporate stakeholders. Although the abstract conception


\(^{215}\) (1995) 13 ACLC 132 at 145. This suggestion is also consistent with the disclosure principles enunciated by ASIC in its draft policy statement “Schemes of Arrangement and ASC Review” (13\(^{\text{th}}\) October 1997) para 16, where it intimated that it would object to a proposed scheme of arrangement which involves shareholders of the scheme company receiving shares in another company, if the information disclosed in the explanatory statement is not the type and standard that the shareholders of the scheme company would receive in comparable situations. This was confirmed by Santow J in Re Archaen Gold NL (1997) 23 ACSR 143 at 145 in which he stated that, where what is being done under a scheme of arrangement is substantially equivalent to a conventional takeover, shareholders should not be deprived of equivalent information, even if that information is not specifically required by the provisions governing disclosure.

\(^{216}\) Cf. the disclosure procedures under s 667C (compulsory acquisition) and s 411-412 (schemes of arrangement). It is suggested that the reduction of capital disclosure provisions can be reviewed in accordance to ExParte Coca-Cola Amatil Ltd (1998) 44 NSWLR 343. There, the court held that a lack of fairness and equity might be found, if materials that are material to a decision on how to vote in a share capital transaction are omitted from the information provided by the company to the shareholders for their consideration, or, if there was a misstatement or error in a material point which may mislead or cause some serious misapprehension to a shareholder, the transaction will be invalidated. See also, Re Albert Street Properties Ltd (1997) 15 ACLC 603 where the court refused to confirm a reduction because there was not sufficient information disclosed by the company.

of fairness and equity or fair and reasonableness is easily understandable, in practice, the actual criterion by which it is to be adjudged in any given circumstances is beset with difficulties casting doubts on the adequacy of the fairness approach which best describes the protection needed by creditors and shareholders wanting.

3.4.2.2.1. Common law Approach

Traditionally under the ‘old law,’ it was a condition precedent to a reduction of capital that the courts would only approve a share capital reduction which was fair and equitable to all classes or group of company’s shareholders. Any reduction which was not fair and equitable was unfair and inequitable and would not be sanctioned. In considering whether there was fairness in a reduction of capital, the courts took the following relevant factors into consideration:

- whether the formal requirements for convening and conducting the general meeting to pass a special resolution have been satisfied;
- where the reduction is believed to adversely affect creditors, whether their interests are adequately safeguarded;
- whether the public, shareholders and every class of shareholders individually and collectively are protected.

Where share capital was being returned, and all relevant shareholders were treated equally, the courts tended to confirm a reduction particularly if it was consistent with the rights of the shareholders on a winding-up. Loss reduction of capital would normally be confirmed on proof that the loss of capital was real and seemingly permanent and so long as the loss was first borne by those shareholders (if any) and who had a deferred right to be repaid in a winding-up.

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218 See, for example, Corporations Law, s 195.
222 Melcann Ltd v Super John Pty Ltd (1994) 13 ACLC 92.
223 Scottish Insurance Corp Ltd v Wilson &Clyde Coal Co Ltd [1949] AC 462
224 Re London & New York Investment Corp [1895] 2 Ch 860 at 867 per Sterling J.
Chapter 3  
3.4. Protection of Creditors and Shareholders (Fairness Test)

The courts subjected a discriminatory or unequal reduction to critical scrutiny particularly if it would result in the shares of dissenting or minority shareholders being cancelled without appropriate procedures.\textsuperscript{225} To this effect, the courts equated fair and equitable value to the ‘fair value’ or ‘fair price’ to be received by those shareholders whose shares were to be cancelled or who were to be compulsorily eliminated from the company. As to the interpretation by ASIC of the law governing selective reduction under s 195 of the law, ASIC, among other issues, believed that an independent experts’ valuation should be carried out to determine if the consideration paid to exiting shareholders was a fair value or fair price for their shares.\textsuperscript{226} Generally, while the common law approaches varied considerably, and may contribute significantly as guiding principles, some of their methods are problematic and questionable. Apart from the limited cases in which the courts have refused to sanction a proposed reduction as ‘unfair’, their various techniques in many circumstances have been applied subjectively, for example, by only inquiring whether the requisite majority have adequate information approved by the reduction.

Conflicts of interest which might cast some doubts upon the wisdom of relying on majority sanction have only occasionally been instrumental in prompting judicial review. In \textit{Re Holders Investment Trust Ltd},\textsuperscript{227} the courts reviewed a compulsory acquisition by starting with a presumption that, a bid is fair if a very large majority of offerees accepted it and that the court should not substitute its own view as to the fairness of the offer. Perhaps, the most fundamental question about the fairness test in this sense is whether it is appropriate to use the circumstances of ‘shareholders as a whole’ in assessing fairness? Arguably, the high level of acceptances will always militate against an offer being unfair to shareholders as a whole. Assuming that an objective of the compulsory acquisition provision is to weigh up the interests of the minority and the majority, the test in its present form gives much latitude to the majority. It is submitted that the common law

\textsuperscript{225} \textit{Re Welsbach Incandescent Gas} [1964] 1 Ch 87.

\textsuperscript{226} See also \textit{Re Shine Fisheries Ltd} (1994) 12 ACSR 627; \textit{Re Deniliquin Corp Ltd} (1994) 12 ACSR 623; \textit{Quatro Ltd v Argo Investments Ltd} (1999) 32 ACSR 239.

\textsuperscript{227} [1971] 1 WLR 583. Also, in \textit{Re Hoare & Co Ltd} (1933) 150 LT 374 at 375, MaughamJ held that “prima facie, the court ought to regard a scheme as a fair one inasmuch as it seems to me impossible to suppose that the court, in the absence of very strong ground, is to be entitled to set up its own view of the fairness of the scheme in opposition to so very large a majority of the shareholders who are concerned.” Contra, \textit{Re Second Standard Royalties} (1930) 66 CLR 288.
approach as to when a proposed reduction is ‘fair’ to shareholders as a whole has not been satisfactory.

3.4.2.2.2. Current Approach

Under the current capital reduction regime, s 256A has developed its own minimum criteria for the determination of fairness.\textsuperscript{228} In accordance with s 256A (b), the purpose of the share capital reduction rules are designed to protect the interests of shareholders by seeking to ensure fairness between the company’s shareholders. Accordingly, s 256B (1) (a) requires a reduction of capital to be fair and reasonable to the company’s shareholders as a whole. Like the old regime, the current legislation tries to strike a balance between two competing policy considerations (i.e., accommodating the desire of a controlling majority and the need to protect the minority from opportunistic behavior and, addressing any conflict of interest).

To determine whether a reduction is fair and reasonable, the court will effectively be asked to assess the ‘fairness and reasonableness’ of a reduction on each kind of shareholder.\textsuperscript{229} ASIC, also has powers to intervene in court proceedings involving a reduction of capital under s 1330 and is likely to do so if a proposed selective reduction is potentially unfair to minority shareholders.\textsuperscript{230} The issue on the determination of fairness, remains a jurisprudential question. It is unclear what is meant by the term, ‘fair and reasonableness’ and whether, the minimum criteria developed under s 256A&B provides the optimum approach for adoption.

\textsuperscript{228} The new share capital reduction regime no longer subscribe to the courts procedure. But, it is apparent that in a contested reduction of capital, where the courts jurisdiction is evoked, the courts might continue to apply the former principles when interpreting s 256B. See, to this effect, Quatro Ltd v Argo Investments Ltd (1999) 32 ACSR 239.

\textsuperscript{229} Re Campaign Holdings Property Ltd (1989) 15 ACLC 762.

\textsuperscript{230} Under s 1324, ASIC may seek an injunction to restrain the share capital reduction. Where a selective capital reduction has already taken place, that is, the relevant shares cancelled, an aggrieved former shareholder may also
Chapter 3 Protection of Creditors and Shareholders (Fairness Test)

In the context of an independent expert’s report in a takeover for example, the ASC ‘PS 75’ provides experts with guidelines for preparing a report on whether the proposed terms of a selective capital reduction or a takeover are ‘fair and reasonable’. ASIC (as is now) has suggested that the words ‘fair and reasonable’ require two separate judgments, in particular, an expert may conclude that an offer is not fair because the value of the offer is less than the true value of the securities, but is nevertheless ‘reasonable’ because in all the circumstances it is unlikely that any higher bid will be received. This reasoning has been judicially disapproved in Re Rancoo Ltd, where Hayne J found some difficulties with this approach and expressed preference for the view that ‘fair and reasonable’ is but a single expression intended to convey a single overall meaning. He expressed concern that in some situations, the Commission’s approach may obscure more than illuminate.232

The Explanatory Memorandum to the ‘CLRA’; 233 in assessing whether or not a proposed reduction was ‘fair and reasonable’ to the company’s members, asserted that the test of fairness focuses on the interests of shareholders who may be directly or indirectly affected by a return of capital such as where the adequacy of the consideration may be in question or where, preference or ordinary shareholders may be prejudiced. The ‘Memo’ further intimated that it is the effect of the reduction not the purpose which needs to be considered and as such stated:

The expression, ‘fair and reasonable’ is intended to be a composite requirement so as to contrast it with the confusion earlier posed by the Australian Securities Commission (ASC) where a similar phrase was being used with a somewhat different interpretation. Factors that might be relevant to determining whether a capital reduction is fair and reasonable to shareholders as a whole include the following:

(i) The adequacy of any consideration paid to shareholders;

(ii) Whether the reduction would have the practical effect of depriving some shareholders of their rights (for example, by stripping the company of funds that would otherwise be available for distribution to preference shareholders);

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iii) Whether the reduction is being used to effect a takeover and avoid the takeover provisions;
(iv) Whether the reduction involves an arrangement that should more properly proceed as a scheme of arrangement.  

The Explanatory Memorandum suggests that the above minimum criteria should have regard not to the commercial interests of the company, but to the interests of the shareholders who are directly and indirectly affected by a reduction. Apparently, a reduction of capital does not have to be fair and reasonable to every member-in this context; it was referring to a selective reduction which contemplates expropriation of the shares of the minority preference shareholders. It put it thus:

The expropriation may only be challenged on the basis that the capital reduction was not fair and reasonable to shareholders as a whole. The statutory test may be satisfied even though the reduction is not fair and reasonable for every individual member. The expropriation may also be challenged as oppressive conduct under s 232-234. However, the fair and reasonable test focuses on the effect and not on the purpose of the reduction. Accordingly, the principles set out in Gambotto v WCP Ltd . . . do not apply to the expropriation of rights under this mechanism.

In Winpar Holdings Ltd v Goldfield Kalgoorlie Ltd, Santow J thought that the words ‘as a whole’ in s 256B required fairness and reasonableness as between majority and minority shareholders, not some one sided allocation. His Honour, took the view that the principles set out in Gambotto v WCP Ltd do not apply to selective capital reductions because s 256C itself seeks to provide protection to shareholders. His Honour said that, ‘fairness and reasonableness’ are to be determined by reference to statute. The general law may, but only to the extent consistent with the statute, provide some

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234 By a ‘composite requirement’ the Explanatory Memorandum meant that the words ‘fair and reasonable’ were synonymous and intended to convey a single overall meaning. Accordingly, there is no scope for concluding that a reduction of capital is fair but ‘unreasonable, or’ reasonable ‘yet unfair’.
235 Explanatory Memorandum, above n 236, para 12.25.
236 (2000)34 ACSR 737; 176 ALR 86.
238 (1995)182 CLR 432. It is to be noteworthy that the relevance of Gambotto principles to reduction under former s.195 were repealed in July 1998. Under the former Corporations Law, the courts were divided on whether Gambotto principles were relevant to a selective capital reduction. (cases, such as, Re Arrowfield Group Ltd (1995)17 ACSR 649 per Cohen J, Re Advanced Bank Australia Ltd (No 2) (1997) 136 FLR 288, were of the opinion that the Gambotto principles applies to a reduction of capital). Santow J considered that the Gambotto principles would apply except that a court would probably not have to be concern itself with the issue of whether the purpose of a reduction was a proper purpose. But on appeal his Honour concur with other judges that Gambotto did not apply).
interpretative guidance. The minimum criteria prescribed by the Explanatory Memorandum to the Corporate Law Review Act 1998 also have merits in similar terms to the common law criteria in determining fairness. However, the minimum considerations leave many lacunae which include:

3.4.2.2.2.1. Difficulties in the adequacy of the consideration criteria.

Firstly, there can be considerable problems with the requirement that a price paid to shareholders might be relevant to determining whether a capital reduction was fair and reasonable to shareholders as a whole. Under both the common law and under current law, the view in a number of cases is that fairness to the minority shareholders largely depends on their receiving an adequate consideration for their shares (that is, a fair value or fair price paid to shareholders). The courts have equated payment of the fair equivalent in money of the value of the shares with equality.

Presumably, reliance on the value paid to shareholders whose shares are cancelled may be an appropriate benchmark for measuring fairness. But there are circumstances in which purely economic considerations would not be decisive. The current law on the maintenance of capital does not require an independent expert valuation for shares. Therefore, while s 256C (2) permits shares of a certain class of members to be cancelled, it is silent on whether such shares cancelled in a selective reduction should be independently valued. To be able to determine that there is an adequate consideration

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239 Winpar Holdings Ltd v Kalgoorlie Ltd (2001) 40 ACSR 221.
240 See, NICON Resources Ltd v Catto (1992) 8 ACSR 219 at 229. In Catto v Ampol (1989) 15 ACLR 307 at 322; (1989) 16 NSWLR 342 at 361, the full court of the New South Wales Supreme Court, refused to confirm a reduction of capital because the price was unsatisfactory. The court took the view that the market price was a poor tool for determining whether corporators have been treated fairly because, a share market price may sometimes trade above the fair and reasonable value and, sometimes trade below since the share market is susceptible to fluctuations driven by unnecessarily rational factors. A market price can be a useful indicator of determining fair value only when the market for that company's securities is active and liquid but, when trading is thin, the market price is a far less reliable indicator of fairness. Similarly, in Austrim Kyles Ltd v Kroll & Ors (No 2) (2002) VSC 193, minority shareholders were eliminated from the company through a compulsory acquisition scheme and paid a fair consideration for their elimination. They however invoke the s 664(3) and s 664F(1) of the Compulsory Acquisition of Shares provisions, arguing that the price which was offered to them as compensation for being eliminated from the company was not a fair price and as such, the transaction could not be ascribed as a fair and reasonable transaction. Contra, the New Zealand case of Re Sheldon (1987)3 NZCLC 100,058 where the court held that in the case of a quoted company, it would be rare for a court to be satisfied that a price substantially above market was not a fair value. (This case was not a capital reduction case but a two step acquisition).
offered to shareholders, it would be anomalous not to take into consideration an independent expert report. The recommendation by ASIC, which suggests that such shares need to be valued by such experts is the preferable approach. Though it has been argued by some authorities that there is a high degree of variation between reputable experts and that, there is no precise mathematical formula for valuing shares, an independent expert valuation remains a crucial weapon for the ascertainment of the value of shareholdings.

Arguably, the adequacy of consideration in the form of money paid for eliminating minority shareholders in large public companies can be a reasonable compensation which can be equated with the fairness criteria. This is so because, such shareholders are often little more than mere purchasers of income. However, the situation may be very different with respect to the interests of minority shareholders in an incorporated partnership. These interests can be very broad. It is unlikely that minority interests in incorporated partnership can be compensated by the simple payment of money and, it would be very difficult to calculate what amount of money would be appropriate. A more workable procedure would be for shareholders to be given the right to seek appraisal of their shares, such as through an independent expert report.

Also, in *Nicon v Catto*, Bryson J held that though fairness of a reduction of capital is primarily an economic matter, the courts must consider matters other than price. His Honour said:

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243 See, ASIC Practice Note 29, “Selective Capital Reductions” [1993] 1 ASIC Digest PN2/15, paras 27; 42.3 (in the context of former s 195) which had recommended that an independent expert report should usually accompany an Explanatory Memorandum for a reduction of capital. A similar view was suggested by the Legal Committee of ‘CASAC’, (The CASAC Committee Report, (Nov, 1994) paras 76.81); See also, *Winpar Holdings Ltd v Goldfield Kalgoorlie Ltd* (2000) 176 ALR 86 at 97. The same approach has been adopted by foreign jurisdictions, such as in the United States (see, V. Mitchell, “The U. S. Approach Towards the Acquisition of Minority Shares: Have We Learned a Lesson?” (1996) 14 C&SLJ 283 at 301.


245 In *Pauls Ltd v Jennifer Mary Dwyer* [2000] QSC 067, Douglas J held that fairness in a scheme of arrangement where value is critical factor, there is the dire need for an independent expert valuation.


247 This point of view finds support also in Q. Digby, “Eliminating Minority Shareholders” (1992) 10 C&SLJ 105, 122.

3.4. Protection of Creditors and Shareholders (Fairness Test)

The fairness and equity of a reduction is primarily a matter of the treatment of the minority shareholders economic interest ... I say primarily, because the decision is discretionary and there could I suppose be some circumstances in which an exclusively economic conspectus was not appropriate because of some personal dealings among those involved or for some other reason.248

3.4.2.2.2. Relevancy or Irrelevancy of the Scheme of Arrangement and Take-over criteria.

One further consideration for the determination of fairness according to the Explanatory Memorandum, relates to whether the reduction should properly proceed by way of a scheme of arrangement. This criterion emanates from Plowman J’s dictum in Re Robert Stephens Holdings Ltd.249 It was there held that to better protect minority shareholders, it is desirable that a selective share cancellation proceed by way of a scheme of arrangement. The courts have judicially questioned this condition in Re Advanced Bank Australia Ltd.250 There, it was argued that, in assessing whether a reduction was fair and reasonable, it is not helpful to inquire whether the reduction involves an arrangement that should more properly proceed as a scheme of arrangement.

The level and quality of disclosure required for an explanatory statement in a members scheme under s 412(1) is arguably, no higher than that which now applies to an explanatory statement under s 256C(4) for a selective reduction. Even if this disclosure reasoning is doubtful, there are other reasons to suggest why scheme of arrangement procedures may be questionable. Firstly, a scheme of arrangement requires court approval, whereas, the new selective reduction of capital provision dispenses with the need for court confirmation, although they may embody a capacity for court challenge.

Furthermore, in Winpar Holdings Ltd,251 Santow J, noted that where the existing minority shareholders are to be compensated for the cancellation of their shares by cash emanating from the company whose capital is being reduced, it is unnecessary to require a scheme of arrangement. Moreover, a scheme of arrangement might not be a reasonable procedure

248 Ibid.
249 (1968) 1 WLR 522 at 524.
250 (1997) 22 ACSR 513 at 530.
251 Winpar Holdings Ltd v Goldfield Kalgoorlie Ltd (2001) 40 ACSR 221.
for a selective reduction of capital because, under a scheme, the majority shareholders have greater influence in determining the outcome of a scheme transaction. For example, if the controlling shareholder is of the view that the economy and the investment market are likely to improve over a certain time frame, it is a threat to shareholders’ interests to initiate any minority freezeout while the share prices are relatively low. Even so, the controlling shareholder is better placed to evaluate the prospect of a target company and may have insight with respect to the company which is not possessed by the minority or the market as a whole. Accordingly, such controllers may be able to structure and present a proposal which is fair on the basis of available information but which does not reflect the company’s likely prospects and as such, refuses the minority the real value for its shares.

It is submitted that, to strengthen the various techniques used in determining fairness, the various considerations under common law and current law must be taken into account in providing useful guidance. The relevancy of the test in other areas of the Corporations Act where a similar language of fairness has been used would also assist as interpretative guidance. In the context of the s 667C(1) compulsory acquisition provision for example, Santow J in Winpar Holdings Ltd v Goldfield Kalgoorlie Ltd turned to s 667C(1) for guidance in interpreting the words “fair and reasonableness” under the selective reduction of capital provisions. Though s 667C (1) speaks of ‘fair value’ and s 256B (1)(a) talks of capital reduction being ‘fair and reasonable to the company’s shareholders as a whole’, Santow J considered that it is appropriate to interpret s 667C(1) and s 256B(1)(a) in a manner which gives ‘a harmonious, practical and mutually supportive operation to each of them’.

Also, in Capricon Diamonds Investment Pty Ltd v Catto & Ors, the Court identified certain principles as crucial to the ascertainment of the fair value of a share capital transaction which included:

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(i) Fair value of an asset is its fair equivalent in money ascertained by a supposed sale by voluntary bargaining between vendor and purchaser, each of whom is both willing and able, but not anxious, and with full knowledge of all the circumstances which might affect value;

(ii) The fact that the units must be disposed of at a fair value should not be a factor leading to a discount or lower valuation than would otherwise obtain. Conversely, it should not be a factor leading to a premium or higher valuation;

(iii) The value of special benefits to the acquirer is not properly to be included in the calculation of the value of the company as a whole. A ‘special benefit’ was defined to include some special potentiality which only one person would buy [which] is to be valued on the basis of a notional sale to that person. In other circumstances, it was equated to the premium which was paid to shareholders as compensation for their shares and for forcibly removed from the company.254

(iv) Fairness must be considered whether a transaction is fair to all shareholders as a whole, rather than whether it is fair to a particular shareholder or class of shareholders in the particular circumstances. In Elkington v Vockbay Pty Ltd255 it was held a market price cannot be taken as a safe indicator of fair value in circumstances of limited trading. Where a large majority of shareholders had accepted an offeror’s bid does not seem to provide any measurable safeguard or, any objective level of fairness to all shareholders;

(v) To determine a reasonable consideration for the value offered to shareholders, the shares must be valued by an independent expert valuer. These criteria may assist in determining fairness but, not all of the s 677C requirements may be relevant for purposes of say, a selective reduction of capital.

Conclusively, fairness must be looked from a point of view of elimination of minority shareholdings. The essential criteria discernible from case law will include, adequacy of the consideration, full disclosure, and a valuation by an independent expert valuer.256

256 These points are already elaborated upon in previous part of this chapter and in other chapters of this study.
CHAPTER FOUR
FINANCIAL ASSISTANCE FOR THE PURCHASE
OF COMPANY SHARES

4.1. Introduction.

This chapter deals with the rule relating to the giving by a company of financial assistance to a person for the acquisition by that person of the company’s own shares. Section 45 of the English Companies Act 1929 was the first to expressly prohibit financial assistance transactions. The provision was intended to prevent the evasion, by indirect means of the restrictions on repurchase by a company of its own shares.\(^1\) To this extent, it can be treated as a fortification of the rule in Trevor v Whitworth.\(^2\) A further rationale was explained in VGM Holdings & Wallersteiner v Moir.\(^3\)

There, Lord Greene suggested that the prohibition was developed to address leveraged buy-outs (i.e., a mischief whereby, a person who has obtained a loan from a third party in order to purchase a majority of a company’s shares, having gained control of the company arranged for the loan to be repaid by the company out of its own funds).\(^4\) However, this chapter will demonstrate that financial assistance does not necessarily breach the capital maintenance doctrine nor lead to asset stripping take-overs.\(^5\)

In reaching the conclusion above, the chapter will also show that creditors and even shareholders are not adversely affected in most cases when a company provides financial

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\(^1\) The most common rationale of the restriction is that it serves to reduce financial agency costs & managerial agency costs i.e., the costs of conflicts of interest between shareholders and creditors and management. The traditional prohibition has been rationalised in most jurisdictions authorising companies to provide financial assistance followed by exceptions and some statutory pre-conditions. See for example ss 260 of the Corporations Act; s 44 of the Canadian Business Corporations Act.

\(^2\) (1887) 12 App Cas 409 (HL). Three factors that influenced the legislature in enacting the financial assistance prohibition provisions appear to have been (i) the protection of creditors and shareholders against the dilution of assets; (ii) the protection of shareholders against efforts by the directors to extend their control; and (iii) the inhibition of take-over bids.

\(^3\) (1942) 1 All ER 224.

\(^4\) See, Great Britain, Report of the Company Law Amendment Committee ("Greene Committee Report") (1926) Cmd 2567, para 30 where such transactions were described as 'asset-stripping' take-over. The Jenkins Committee was doubtful if the ban on financial assistance would be an anti-manipulation device. (See, Great Britain, Board of Trade Report of the Company Law Committee ("The Jenkins Committee Report") (1962) Cmd 1749 paras 176-187.

\(^5\) See the discussion in 4.2 below (legislative history), 4.3.4.1 (problems of defining and determining financial assistance) and 4.3.4.2 below (Take-over financing).
assistance for the purchase of its own shares. An absolute prohibition on financial assistance will not benefit creditors or shareholders, rather permitting financial assistance with safeguards such as the dual solvency requirement will. The discussion will also seek to demonstrate that if share buy back and reduction of capital are exempted from the operation of s 260A, the same must be true for dividend distribution. Lastly, the chapter aims to demonstrate that the current mechanisms in Australia regulating financial assistance do not go far enough in protecting creditors and shareholders from financial assistance transactions.

The prevention of asset stripping takeovers has fallen away as a major rationale and been replaced with the maintenance of share capital and protection (i.e., prevention of the erosion of share capital), and the protection of those in the corporation with limited powers (minority shareholders and creditors) from sharp practices of those with power (controlling shareholders, whether before or after a takeover, directors and officers).

However, while the policy objectives have crystallised, the general scope of the financial assistance provision is still uncertain. The first part of the study develops a legislative framework of the rule in Anglo-Australian law; the second evaluates the current Australian regulatory mechanisms in a comparative context, expose their weaknesses and offers possible suggestions for reform. The proposed reform takes us back to the discussion in Chapter one which demonstrates that the maintenance of share capital has very little part to play in protecting creditors.

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6 See, for example, section 4.3.1 below (the materiality provision), section 4.3.4.3.1 below (Directors duties, insolvent trading provisions and solvency requirements); s 4.3.4.2 below (takeover financing); note 197 below and, the analyses in Chapter 8, s 8.3.3 (relating to oppression remedy provisions).
7 Refer to section 4.3.4.1 (problems of definition), and s 4.3.4.3 below (Regulation of financial assistance and conflicts of interests).
8 See, for example, Corporations Act 2001 (Cth), s 260A (1) (a).
9 Refer to s 4.3.3 below (problem of definition), 4.3.4.2 below (takeover financing) and the exemptions from financial assistance.
4.2. Legislative Framework and History of the Provisions

This part of the study has many significant roles to play in the understanding of the financial assistance legislation and the capital maintenance doctrine. Firstly, the section aims at tracing the history of the development of the provisions from a certain time frame as they evolved in Australia and the United Kingdom. This will demonstrate how the financial assistance prohibition reinforces the Trevor rule which originally prohibited a company from dealing in its own shares by other persons, but not necessarily prohibiting a company from risking its assets in connection with the acquisition of its shares by other persons. The legislative history also has the objective of illustrating how from a time frame, case and statutory laws, law review reports contributed in the enactment of the various provisions of the financial assistance legislation, and how they subsequently lead to a repeal, amendment or consolidation of the current provisions found in the UK and Australia. This is important because it shows difficulties in interpretation, but also, to clarify certain over rigorous judicial interpretations. (This trend illustrates weaknesses in draftmanship, loopholes in creditor protection or interpretative difficulties).

The history of the legislation will further demonstrate how the Greene Committee which initially recommended the ban on financial assistance misdiagnosed its solution to the problem. The prohibition, it will be illustrated was irrelevant and too restrictive, preventing commercially desirable transactions which did not breach the capital maintenance doctrine from being pursued. It will also be demonstrated how the rigorous nature of the ban was subsequently relaxed in both jurisdictions illustrating a divergence between capital maintenance and prevention of leveraged buy-outs, and how capital maintenance has prevailed. This shift in emphasis is apparent in the original policy rationale (which was nullifying an asset ‘stripping’ takeover) to the prevention of the erosion of share capital and to the protection of creditors and shareholders. The historical development also aims at demonstrating how most common law jurisdictions (Australia), initially adopted the English position without much inquiry as to its suitability for Australian companies. It will also illustrate that though both Australia and the UK relaxed the ban in subsequent years, they took similar but different approaches in
regulating financial assistance and protecting creditors and shareholders from a breach of the maintenance of capital doctrine. The history also compares the complexity of the traditional prohibition and the relative simplicity of the current law in both jurisdictions. Lastly, the historical framework will assist in providing the basis for the policy debate in subsequent sections and to draw the concluding remarks as to whether to retain the law in its present state in Australia or with some tweaking with the old regime.

4.2.1. The English History.
The Trevor rule was reinforced by parallel statutory provisions dealing with the financing by a company of the purchase of its own shares by others, and related acts.\textsuperscript{10} Under the rule in Trevor v Whitworth,\textsuperscript{11} a company was prohibited from dealing in its own shares by other persons; but the rule did not necessarily prohibit a company from risking its assets in connection with acquisitions of its shares by other persons. In British & American Trustees & Finance Corporation v Couper,\textsuperscript{12} Rich J was of the opinion that a loan by a company to a person to purchase its own shares was not within the purview of the rule.

The genesis of the legislation prohibiting companies providing financial assistance for the purchase of their own shares may be found in the Greene Committee Report.\textsuperscript{13} In its report published in 1926, it stated:

A practice has made its appearance in recent years which we consider to be highly improper. A syndicate agrees to purchase from the existing shareholders sufficient shares to control a company, the purchase money is provided by a temporary loan from a bank for a day or two, the syndicate’s nominees are appointed directors in place of the old board and immediately proceed to lend to the syndicate out of the company’s funds (often without security) the money required to pay off the

\textsuperscript{10} This became known as the rule (prohibition) on ‘financial assistance’. It was intended to ensure that persons who acquired shares in a company did so from their resources and not with the financial assistance of the company. The term ‘financial assistance’ has no clear cut meaning. The refined meaning developed by case law and under the Companies Act 1929, s 45 recognised that financial assistance might for example, take the form of a loan, guarantee, or the provision of security.

\textsuperscript{11} (1887) 12 App Cas 409 at 415-7 (HL). There, a company purchased its own shares where the value of the purchase amounted to more than one fourth of the paid-up capital of the company. The court ruled that if the reason which induced the company to purchase its shares was that they might sell them again, this would be trafficking in the shares, and clearly unauthorized. If it was to retain them, this would be an indirect method of reducing the capital of the company.

\textsuperscript{12} [1894]AC 399.

\textsuperscript{13} Greene Committee Report, above n 4. This Committee was appointed in 1925 to review the Companies (Consolidation) Act 1908.
bank. Thus in effect the company provides money for the purchase of its own shares. This is a
typical example although there are, of course, many variations. Such an arrangement appears to us
to offend against the spirit if not the letter of the law which prohibits a company from trafficking in
its own shares and the practice is open to gravest abuses.\footnote{14}

The Committee recommended:

That a company should be prohibited from directly or indirectly providing financial assistance in
connection with a purchase (made or to be made) of their own shares by third persons, whether
such assistance takes the form of a loan, guarantee, the provision of security or otherwise. This
should not apply in the case of companies whose ordinary business includes the lending of money,
to money lend in the ordinary course of such business, or to schemes by which a company puts up
money in the hands of trustees for purchasing shares of the company to be held for the benefit of
employees or to loans direct to employees for the same purpose.\footnote{15}

This recommendation was adopted by most common law jurisdictions.\footnote{16} In particular, it
resulted in the enactment of section 45(1) of the \textit{Companies Act 1929},\footnote{17} which provided:

It shall not be lawful for a company to give whether directly or indirectly, and whether by means of
a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of
or in connection with a purchase made or to be made, by any person of any shares in the company
or where the company is a subsidiary in the holding company.\footnote{18}

\footnote{14} Ibid at 14, para 30. In \textit{Re V.G.M. Holdings Ltd} [1942] Ch 235 at 239; 1 All ER 225 Lord Greene MR. Stated:
Those whose memories enable them to recall what had been happening for several years of the last war (WW
I) will remember that a very common form of transaction in connection with companies was one by which
persons call them financiers, speculators or what you will–finding a company with a substantial cash balance
or easily realisable assets, such as war loans, bought up the whole, or the greater part of the shares of the
company for cash and so arranged matters that the purchase money which they then became bound to
provide was advanced to them by the company whose shares they were acquiring, either out of cash balance
or by realisation of its liquid investments. That type of transaction (LBO) was a common one, and it gave rise
to great dissatisfaction and, in some cases, great scandal.

\footnote{15} Ibid para 31. The Report referred to a practice of ‘share trafficking’ in support of its recommendation for the ban.
Similarly, as will be seen in the Australian case of \textit{Darwall v North Sydney Brick & Tile Co} (1989) 15 A CLR 230
at 256, Kirby J expressly stated that the purposes of the ban on financial assistance ‘include the avoidance of the
manipulation of the value of shares by companies and their officers dealing in such shares’.

\footnote{16} See for example, s 45 of the \textit{Victorian Companies Act 1938} (Australia), s 86Bis (2) of the \textit{Companies Act 1926}
(South Africa); s 67 of the \textit{Companies Act 1955} (New Zealand).

\footnote{17} (19 & 20 Geo V. c. 23). Section 45(1) was worded in similar language to the Greene’s Committee
Recommendation. The section provides the general provision prohibiting financial assistance, then followed three
provisions which excluded from the subsections prohibition, the lending of money in the ordinary course of
business by a company which ordinarily lends money and provision of loans by a company for acquisition of
shares by its employees.(s 45(2)).

\footnote{18} Internationally, the Canadian Parliament followed the UK lead in 1930 to add an identical s 45 to the \textit{Canadian
Companies Act} (RSC. 1927 C.27), s 57D. But, unlike the UK, the Canadian Federal Statute combined the new
share repurchase financial assistance provision with the then existing Related party financial assistance. Most
Canadian provinces added a similar prohibition to their Companies legislation. See for example; \textit{Companies Act 1934},
(SC.1934, c 35) s 151(1); s 152(1) of \textit{Companies Act (RSC. 1960, c 67)} which later transplanted s 54 of the
1948 Companies Act (UK). Earlier Canadian cases following the \textit{Trevor rule are: R v Intrigshoe Ltd} [1924]4 DLR 625; \textit{Northern Electricity &Manufacturing Co v Cordova Mines Ltd} (1914) 31 OLR 221; where Fisher J held that
Section 45(1) had some weaknesses.\textsuperscript{19} Firstly, it did not prevent a company from providing financial assistance in connection with acquisitions of shares in any of its subsidiaries. Secondly, as held in \textit{Re V.G.M Holdings Ltd},\textsuperscript{20} s 45 covered the giving of financial assistance to purchase shares but not to subscribe for them. As a consequence, s 45 was amended to be later consolidated as section 54 of the \textit{Companies Act 1948}. Section 54, prohibiting financial assistance by a company for the purpose of, or in connection with a purchase or subscription made by any person of shares in the company, replaced the provision reviewed in \textit{Re VGM Holdings}.\textsuperscript{21}

However, the language of s 54 was imprecise. For instance, the interpretation of the phrase, ‘for the purpose of or in connection with’ prevented companies from taking a course of action which made good business sense. Gower and Davies described the section as a ‘notorious section’ in the sense that, in its attempt to ban the provision of financial assistance, it hit the innocent and failed to deter the guilty.\textsuperscript{22} Section 54(1) also, made void for illegality any form of financial assistance to purchase the company’s shares or those of its holding company and any security by or to the company in respect of that assistance.

\textsuperscript{19} The Greene Report and s 45 of 1929 Act were faltering in many respects, aside from the \textit{Re VGM Holding case} where it was held the section was restricted to only ‘purchase’ and not ‘subscription’. Section 45 did not prohibit loans to shareholders and directors. However, the Cohen Committee recommended in 1945 (Report of the Company Law Amendment Committee (1945) Cmdn, at paras 49-50), that it should be made illegal for any loan to be made by a company to its directors. Section 45 was amended to be inserted as s 190 of the 1948 Companies Act, as a new provision on ‘Related Parties’. (This was applied only to directors and not shareholders-meaning loans to shareholders could be used by-bypass the prohibition). In \textit{Lodge v National Union Investment Co Ltd} [1907] 1 C 300 at 306, it was posited that apart from interpretative difficulties, s 45 also suffered from the more fundamental flaw in the sense that, it failed to protect a vulnerable company’s assets from being dissipated in the course of prohibited transactions. As will be seen under Australian position, a provision similar to s 190 was introduced in the form of s 125 of the \textit{Uniform Companies Act (UCA) 1961}, which was replaced by s 230 of the \textit{Companies Code 1981}.

\textsuperscript{20} [1942] Ch 235.

\textsuperscript{21} Section 54 of the 1948 Act extended s 45 to cover its loophole (casus omissus) by reproducing the prohibition in its extended form, prohibiting the issue of new shares. The types of transactions which will breach s 54 range from the ‘smooth’ and direct loan of money by the company for the purpose of assisting a person to purchase shares in the company as occurred in \textit{Dressy Frock Pty v Bock} [1951] 51 SR (NSW) 390 to the much more complicated transactions expoused in \textit{Victor Battery Co v Curry’s Ltd} [1946] 1 All ER 519. Gower and Davies, \textit{Gower and Davies Principles of Modern Company Law} 7th (ed) (London: Sweet & Maxwell, 2003) at 260). Moreover, this commentator posited that, it was held in the much criticised \textit{Victor Battery Co v Curry’s Ltd} [1946] Ch 242 and \textit{Curtis Furnishing Stores Ltd v Freedman} [1966] WLR 1219 that a security given by the company to secure a loan made to finance the purchase of its shares was not avoided. For a detail commentary on s 54, see R. Instone, “Section 54 and all that” [1980] \textit{JBL} 99.
Furthermore, Harman J in *Essex Aero Ltd v Cross*,\(^{23}\) noted that the section was badly drafted and its terms appeared to inculpate the company giving rise to problems of illegality. His Honour, further said that the result of this poor draftmanship was generally honored more in the breach than in the observance.\(^{24}\)

In 1962, the Jenkins Committee, in considering the issue of financial assistance, and particularly the inadequacies of section 54 of the 1948 Act, doubted whether it was worth retaining the provision as an anti-market manipulation device. The Committee, while refuting the Greene Committee’s attempt to link the problem to capital maintenance issues, nevertheless recognised that there were good reasons for retaining and strengthening the provision.\(^{25}\) The Committee remarked that it is justifiable to prohibit absolutely a certain practice or range of transactions, because of the likelihood of abuses being committed in those transactions and the perceived inadequacy of other laws to provide redress for those abuses.\(^{26}\) The Jenkins Committee considered s 54 to be a prophylactic or preventive provision, which operated to prohibit some transactions which were unobjectionable. In the Committee’s opinion, ‘malpractices occur only in a small minority of cases’.\(^{27}\) The Committee stated that the policy behind prohibiting financial assistance was primarily to

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\(^{23}\) [Unreported, 17th Nov 1949].

\(^{24}\) Ibid.


Many witnesses complained that s 54 is drawn in terms so wide and general that it appears to penalise a number of innocent transactions; some indeed questioned whether the section served any intelligible purpose and suggested that it might be repealed. Others, on the other hand, felt that the section should be clarified. There seems to be general agreement that it was widely disregarded. In its final recommendation which contains a clear statement of a creditor-oriented reason for banning financial assistance, it stated:

If people who cannot provide the funds necessary to acquire control of a company from their own resources or by borrowing on their own credit, gain control of a company with large assets on the understanding that they will use the funds of the company to pay for their shares it seems to us all too likely that in many cases the company will be made to part with its funds either on inadequate security or for an illusory consideration. If the speculation succeeds the company and therefore its creditors and minority shareholders may suffer no less, although their interests will have been subjected to an illegitimate risk; if it fails, it may be little consolation for creditors and minority shareholders to know that the directors are liable for misfeasance.

\(^{26}\) Also influenced by the 2nd European Company Law Directive (13th December 1976) (77/91/EEC-1977 OJ L261) (hereinafter, 2nd EC Directive) which seeks to coordinate on a community-wide basis the requirements for the formation of public limited companies and the maintenance and alteration of their capital, in its art 23.1 it was provided that with certain exceptions, a public company may not advance funds, nor make loans, nor provide security with a view to the acquisition of its shares by a third party.

\(^{27}\) The Jenkins Report, above n 25 at 176-187. Jenkins Report remarked that there was uncertainty in the scope of s 54 and there was the consequent difficulty of knowing which transactions were prohibited and which were lawful.
protect creditors, and additionally, to protect minority shareholders. It recommended that the prohibitory wording of s 54 be retained. It further recommended that the provision be strengthened so that, financial assistance is allowed only if:

- a statutory declaration of solvency were made by the directors and filed with the Registrar of Companies; and
- each transaction was approved by a special resolution (75%) passed at a general meeting of the company’s members.

The requirements of the 2nd EC Directive & Jenkins Committee recommendations resulted in the enactment of s 88(1) of the Companies Act 1980. Spurred on by critical reaction to Belmont Finance Corporation Ltd v Williams Furniture Ltd (No 2) & Armour Hick Northern Ltd v Whitehouse, s 88(1) of the 1980 Act was later recast as sections 42-44 of the Companies Act 1981. Section 42 was introduced for the purpose of dispensing any ...
doubts resulting from the query raised in Belmont Finance as to whether a transaction entered into partly with a genuine view to the commercial interests of the company, and partly with a view to putting a purchaser of shares in the company in funds to complete his purchase, was in breach of s 54. The new section was re-enacted in a modified form and applies to all companies.

By way of contrast to previous Acts, the prohibition now found in s 42, applies to the acquisition of shares rather than purchase or subscription so that, it clearly includes the transfer of shares otherwise than for cash. Moreover, the ban now only applies to financial assistance given ‘for the purpose’ of an acquisition and no longer in ‘connection with’ as was the case under the 1948 and 1980 Companies Acts. The purpose of that deletion was to clarify the legitimacy or illegitimacy of transactions in connection with share acquisitions and to moderate certain over rigorous judicial interpretations of those restrictions. Nonetheless, the ambit of s 42 is far from easy to discern, for the word ‘purpose’ is capable of several different shades of meaning.

Due to certain disadvantages involved in the shareholder approval system in ss 42-44 of the 1981 Act, and the difficulties in interpreting the ‘purpose’ test, the 2nd EC Directive,
strongly suggested that at the European level, financial assistance is seen as part of, or at least an extension of the general principle that a company must not reduce its capital by means of share acquisitions. Sections 42-44 were consolidated and incorporated as sections 151-158 of the Companies Act 1985.37 Generally, the 1985 Act introduced some welcome changes.38 By virtue of s 151(1) a company cannot give financial assistance for the purpose of acquiring its own shares. The section also provides that when an individual has borrowed money to purchase a company’s shares, the company cannot thereafter take any steps to reduce or discharge the liability. The rationale of s 151 is to protect the company, its creditors and members from the diminution of the company’s net assets.39 Section 152 contains specific definitions of various expressions used in Pt V. Ch VI. This includes the wide meaning giving to financial assistance.40 In addition to the examples given to represent financial assistance,41 it includes any loans, or other agreement under

37 Companies Act 1985, ss 151-158, Pt V Ch VI. The new rules were intended to define more precisely the conduct which it was sought to prohibit. The words ‘in connection with’ were deleted and the emphasis shifted to ‘the purpose’ or ‘predominant purpose’ of the transaction. Express reference to the timing of assistance was included. The prohibition is applied to the acquisition of shares rather than to their purchase or subscription. The reference in s 54(1) of the provision of assistance ‘to pay any person’ was omitted.

38 Sections 151-153 distinguish between various categories of transactions. First, there are the categories of financial assistance listed in s 152(1) (a) (i-iii) which are prohibited whether or not there is any diminution in net assets, unless s 153 applies. Second, there is financial assistance of a kind not specifically mentioned in s 152(1)(a)(i-iii). This does not contravene s 151 provided the company has positive net assets and the reduction in actual net assets is immaterial. Third, there are those which although carried out for the purposes of an prohibition by the principal purpose defences in s 153 (1) & (2). It is clear from the way in which s 151-155 are drafted that they cover financial assistance in many forms apart from loans, guarantees and the provisions of security (as found under s 152(3)). The general mischief however remains, the same namely that resources of the target company and its subsidiaries should not be used directly or indirectly to assist the purchaser financially to make the acquisition.

39 Section 151(1) prohibition applies to the giving of assistance before or at the time of the acquisition and also to assistance given for the purpose of reducing or discharging a liability already incurred. For example, where a successful takeover bidder uses the funds of a target to repay a lender who financed the bids (s 151(2)). This subsection may protect certain group of financial manoeuvres after a new subsidiary has been acquired for instance, where all the assets of all the subsidiaries of the acquiring company to be charged to secure it. This security is purely a consequence of the acquisition and was not incurred for the purpose of the acquisition. It may also be questionable as to whether there will be any problem with a successful offeror using the targets assets to help discharge the take-over costs. It is submitted that the giving of financial assistance such as the provision of information or the payment of minor costs in connection with a purchase of shares is not covered by s 151. Thus, companies will safely be able to rearrange the forms of their assets to facilitate a take-over or reorganisation provided that assets are not significantly reduced. This policy objective as will be seen in subsequent sections of this chapter, has changed over time in the sense that it is no longer confined to the maintenance of capital doctrine but has been relaxed to allow companies to pursue financially worthy commercial transactions. The original rationale for the introduction of the financial assistance provisions by the Greene Committee in 1926 was the prevention of ‘asset-stripping’ takeovers, now reflected in ss 152(1)(a)(iv) & 152(2)

37 Companies Act 1985, s 152(1) (a).

40 See, for example, gifts, loans, guarantees, releases, waivers and indemnities (s 152 (1)).
which the obligations of the company giving the assistance are to be fulfilled before the obligations of another party to the agreement, and the novation of a loan or of such other agreement, or the assignment of rights under it. The effect of s 152 is that, even if the financial assistance does not fall within the specific types of assistance that the draftsman were able to foresee, it will nevertheless be unlawful if the company has no net assets or if the consequence of the assistance is to reduce its net assets to a material extent.

Sections 153-154 provide a number of exceptions to the financial assistance prohibition, thereby, relaxing the ban in certain circumstances. For purposes of a public company, financial assistance is exempted if the company has net assets which are not thereby reduced or, to the extent that they are thereby reduced, the assistance is provided out of distributable profits. The important exception to the basic prohibition, now contained in s 153, was introduced in an attempt to exempt bona fide transactions from the taints of illegality. However, it seems from the decision of the House of Lords in Brady v Brady the first reported case to consider the scope of s 153 that the attempt has largely failed.

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42 For example, where a company which is a diamond merchant sells a diamond to a dealer for $100,000, payment to be in 12 months hence, the intention being that the dealer will sell the diamond at a profit or borrow on its security thus putting him in funds to acquire shares in the company.

43 Section 152(1)(a)(iii). If the assistance is one or more of those types found under s 152(1)(a)(i-iii), it is irrelevant whether or not the net assets of the company are reduced by reason of the assistance. In some cases, such as gifts, they will be, but in others (such as loans or guarantees) they may or may not. However, s 152(1)(iv) concludes that any other financial assistance given by a company, the net assets of which are thereby reduced to a material extent, or which has no net assets. (‘net asset’ defined as the aggregate of the company’s assets, less the aggregate of its liabilities(s 152(1))).

44 See, Gower and Davies, above n 22 at 262.

45 Section 153 (3-5) inclusive, makes reference to money lending in the ordinary course of business, contributions to employees share schemes (s 153(4)&(5) as amended by s 132 of the 1989 Act).

46 Section 154(1) refers to ‘distributable profits’ as ‘profits out of which the company could lawfully make a distribution equal in value to that assistance’, including if the assistance comprises a non-cash asset, any profit available for the purpose of a distribution in kind under s 276. There is a special relaxation under s 155- s 158 for private companies.

47 Section 153 lists a number of transactions which are not prohibited by s 151. The exceptions here(under s 153) appear to have been drafted for two reasons: (i) to confirm dicta in Belmont Finance(No 2)- as to the lawfulness of financial assistance given with different things (‘purposes’ in view and, (ii) to reverse the decision in Armour Hicks where it was held that the repayment by its subsidiary of a holding company’s debts, which was part of a scheme whereby shares in the holding company were to be purchased from the creditor by directors of the two companies, fell foul of the repealed s 54-such a scheme is now lawful.

48 [1988] 2 WLR 1308. This case alongside others like Porrett v Guppy’s [1966] 2 BCLC 34; Barclays Bank plc v British & Commonwealth Holdings plc [1985] BCC 19, has not only made the financial assistance provisions in the 1985 Act much criticised, but, a case like Brady v Brady for example, has rendered the ‘principal purpose’ and ‘larger purpose’ tests created by s 153(1) & (2) almost impossible to apply. One may be inclined to think that even in its restricted state following the Brady case, s 153 retains the ability to save some transactions from illegality. Nevertheless, s 151 now seems set fair to continue, in large measure, its predecessor’s long career of striking
Sections 155-158 inclusive contain relaxation for private companies only. A private company is permitted under s 155(2) to give financial assistance so long as the assistance does not reduce its net assets or, to the extent that it does, the assistance comes out of distributable profits. Shareholder consents are also to be obtained and certain other procedural requirements are to be satisfied.\textsuperscript{49} The ability of private companies to be provided with a more liberal procedure has been characterized as the “Whitewash procedure”.\textsuperscript{50}

Nourse LJ in \textit{Parlett v Guppy}\textsuperscript{51} remarked that the contrast between the complexity of ss 151-158 and the relative simplicity of their predecessor s 54 is explained by Parliament’s evident intention to relax the rigidity of the former regime in certain respects, more especially in its application to private companies. One such relaxation, applicable to both public and private companies alike, is that assistance, not otherwise objectionable, which does not reduce the net assets of the company to a material extent, is no longer objectionable. As to liability for breach, if s 151 is contravened, the company and every officer in default are liable to a fine and, or imprisonment for up to two years (s 151(3)).
The penalty of £100 that existed under the old law (s 54 of 1948 Act) has now been increased to a fine of unlimited amount.\textsuperscript{52}

Despite early cases\textsuperscript{53} to the contrary, there can now be no doubt that a transaction in breach of the financial assistance prohibition, is void as between the parties and any property transferred in pursuance therefore is irrecoverable.\textsuperscript{54} Accordingly, directors who procure the company to enter into a transaction infringing the section together with any third parties are compelled to an action in breach of trust to reimburse the company for any loss suffered.\textsuperscript{55} Following a period of consultation as to whether the 1985 Act needed to be reformed, the Department of Trade and Industry (DTI), produced its first proposals for reform in October 1994. In relation to public companies, the DTI suggested that, subject to the constraints of the EC Second Directive:

- the effect of \textit{Brady v Brady} be reversed by replacing the ‘principal purpose’ and ‘larger purpose’ exceptions with a new test whereby financial assistance would not be prohibited where the company’s \textit{predominant reason} for entering the transaction is not to give financial assistance;
- a new provision be introduced stating that a transaction would not be void solely on the basis of any unlawful financial assistance.\textsuperscript{56}

\textsuperscript{52} See, Sch 24 of the 1985 Act. There civil and criminal consequences of a breach of s 151 have stirred controversy in England and other countries like Australia which have adopted similar provisions. As decided in the \textit{Victor Battery} case, commentators have argued that the objective of the liability is viewed as not to protect the company but to punish it and its officers (see generally, Farir, \textit{Farrar’s Company Law}, [1992] at 198-200. In comparison, \textit{Victor Battery} seems to conflict with \textit{Curtis Furnishing Stores Ltd v Freedman} [1966] 1 WLR 1219. The issue of liability for breach of s 151 was qualified and certain amendments were made which include: (i) an agreement to provide unlawful financial assistance being unlawful is unenforceable by either party to it: \textit{Brady v Brady} [1988] 2 WLR 1308; (ii) however, the illegality of the financial assistance given or provided by the company normally does not taint other connected transactions, such as the agreement by the person assisting to acquire the shares (This argument is quite obviously fallacious-in the sense that it is difficult to sever a transaction that is illegal to make one part legal and the other part illegal); (iii) if the company has unlawfully given financial assistance, the transaction will be void, but however in this case, all will depend on the nature of the financial assistance: \textit{Heard v O’Connor} (1971) 2 All ER 1105.

\textsuperscript{53} See, \textit{Spink (Boumanse) Ltd v Spink} [1936] Ch 544; \textit{Victor Battery Co Ltd v Curry’s Ltd} (1946) 1 All ER 515.

\textsuperscript{54} \textit{Heald v O’Connor} (1971) 2 All ER 1105.

\textsuperscript{55} \textit{Gray v Lewis} (1873) 8 Ch App 1035. In like manner, in accordance to the ruling in \textit{Belmont Finance Corporation v Williams Furniture Ltd (No 2)} [1980] 1 All ER 393 at 404, participants in breach of s 151 may be sued by the company for the tort of conspiracy.

\textsuperscript{56} In the 1990s, the DTI issued a number of consultative documents on reform of the financial assistance provisions of the company legislation relating to financial assistance. These include: Company Law Review: Proposals For Reform of ss 151-158 of the Companies Act 1985 (DTI Consultation Paper) (1993). Consultation Paper on Financial Assistance (DTI 1996). In its 1997 (ed), DTI initially suggested removing private companies from the scope of the Company’s Act 1985 altogether and the enactment of a clearer set of rules for private companies on prohibited and permitted finance assistance. After consultation however, it withdrew that suggestion and proposed
In response to the DTI’s proposals, in 1997, the Law Society’s Standing Committee\(^{57}\) indicated that it favoured the ‘predominant reason’ test, having itself previously suggested that test. However, its recommendation was subjected to three provisos\(^{58}\):

- that the focus for this test be the result which the company has in mind when giving the assistance, rather than the reason for entering the transaction;
- that the company should have to establish some identifiable goal beyond merely furthering the company’s interests in a general way; and
- that the good faith requirement currently found in s 153(1) (b) be retained.

While these proposals and recommendations are regarded as containing useful suggestions, commentators considered that the issues needed more thought before an alternative to the present provision could be adopted.\(^{59}\) However, the proposals are yet to be fully implemented, and so the law as it stands under the 1985 Act still prevails. The relevant provisions in the Companies Act 1985 benefit from the distilled wisdom of case and practical experience that was built up in relation to their predecessors. As a result, they are undoubtedly much more precise and focused than those which they replaced. Nevertheless, they are still not models of good drafting and they remain obscure in several key respects. Partly because of the uncertainty about the precise scope of the ban and the exceptions to it, the range of practical situations in which the possibility of there being a financial assistance problem can crop up is huge.\(^{60}\)

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\(^{57}\) The Law Society’s Standing Committee on Company Law: Company Law Reform—Financial Assistance for the Acquisition of its Own Shares (Series No 344, January 1997).

\(^{58}\) For the purpose of private companies, the Law Society Standing Committee (ibid) proposes that private companies be removed from the scope of ss 151-154 altogether and that ss 155-158 be replaced by a ‘similar and clearer’ regime allowing private companies to provide financial assistance where that assistance is not ‘materially prejudicial’ or, if this test failed, where the members of the company approve the transaction in advance, by a special resolution.

\(^{59}\) Refer to Lambert who remarked that, in DTI’s own words, ‘It became clear that their suggested draft legislation ran a serious risk of producing a result even more complex, and obscure, than the present legislation’. (L. Lambert, (1997) 18(6) Co Law 186).

\(^{60}\) Some commentators posit that the ambit of the financial assistance provisions in the current law is broader than is necessary to ensure capital is not returned to shareholders. They are of the opinion that the basic prohibitions apply to any assistance which depletes the company’s ‘net assets’, regardless of whether it has distributable profits, and even to some transactions such as loans which may not deplete its assets at all. The net assets are measured according to the book value at the time of the financial assistance. A loan to, or a guarantee on behalf of, an acquiror will only deplete the targets net assets where the acquiror is of doubtful solvency. (See, generally, E Farrow, Company Law and Corporate Finance (Great Britain: OUP, 1999) at 377; J. Armour, “Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law” (2000) 63 MLR 368. Cf, Hill v Mulish & Peake [1999] BCC 325, 331.)
4.2. History of Legislation (Australia)

4.2.2. Australia’s Legislative History.

Prior to the Uniform Companies Act, the various states enacted a financial assistance provision which was based on section 37 of the Canadian Business Corporations Act of 1890. The first such enactment was s 30 of the Victorian Companies Act of 1890. In 1915 influenced by the Canadian decision, Hughes v Northern Electric and Manufacturing Co, the Victorian Parliament further extended the prohibition in s 273(1) of the Companies Act 1915. It stated:

except as provided in this Act, no company shall either directly or indirectly purchase or deal in or lend money or make advances or allow discounts upon the security or pledge of its own debentures or debenture stock.

With the enactment of s 45 of the Companies Act 1929 (UK), s 273(1) of the Victorian Companies Act 1915 was amended to reflect the recommendations of the Greene Committee. This was first enacted as s 57 of the Companies Act 1931 (Queensland) and, in 1938, an identical section appeared as s 45 of the Victorian Companies Act 1938. Section 45(1) of the Victorian Act restated verbatim the financial assistance provision in the English Act of 1929. The relevant policy objectives of s 45 as illustrated in Dressy Frocks Pty Ltd v Bock included the prevention of injury to a company by lending of its

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61 Uniform Companies Act, 1961/62 (UCA) (No 6839).
62 Section 30 provides:

No company shall lend or advance money on the security of shares in the company, nor shall any company have a charge on any shares in the company belonging to a shareholder other than a charge on a share for the calls due on such shares.

Within the same year, to reinforce the Trevor Rule, the section was structured to read:

"No company shall either directly or indirectly purchase or deal in, or lend money, or make advance upon the security or pledge of any shares of its own capital stock." Particularly noteworthy is that at the relevant time, there was no provision in force in the UK until the Companies Act 1929 when s 45 was inserted into that Act. With this understanding, the view may be taken that the Australian State of Victoria, took the lead in legislating on the financial assistance prohibition.

63 (1915) 21 DLR 358 (Can Sup). Compare this case with a dicta in the Australian case of Durack v West Australian Trustee Executor and Agency Co Ltd (1944) 72 CLR 189.
64 Companies Act 1915 (Vic) (No 2631) Assented to on the 1st of October 1915.
65 It is very unclear, whether this provision covers shares as distinct from debentures.
66 Similarly worded in other States, were s 148 of the Companies Act 1936-37 (NSW); s 62(1) & 63(1)(B) of 1934 Companies Act (SA) and s 67(1) of the Companies Act 1962 (SA).
67 [1951]SR (NSW) 316. See, also, Shearer Transport Co Pty Ltd v McGrath [1956] VLR 361. Further policy reasons were provided in, O’Neill v O’Connell (1946) 72 CLR 101 at 132. The sections were intended to punish the directors by a penalty of £100 so as not to destroy the right of the company to recover its own money which it had lent. It was never intended to make repayment of a loan void and unenforceable. Both ss 45(1) & 148(1) for example, did not make the lending by a company void although, s 185 of the 1938 Act (Vic) says a security shall be void in certain circumstances. Thus, in Durack &Ors v West Australian Trustee Executor and Agency Co Ltd (1944) 72 CLR 189 and Lorang v The King (1931) 22 Cr App R 167; the Court of Criminal Appeal said that it was unable to see any difference between a company buying its own shares and the company making a loan authorised
assets to buy its own shares; prevention of the weakening of a company’s structure by reducing its capital and the protection of creditors. As a result of most of the shortcomings of s 45 of the 1929 Act (UK) identified, in particular in Re VGM Holdings, s 45 of the 1938 Act (Vic) was amended to be included as s 67 of the Uniform Companies Act 1961. Like s 54 of the 1948 Act (UK), it applied to the provision of financial assistance in connection with a purchase of, or subscription for shares. While the predecessors of s 67 were prophylactic in intention and did not require impoverishment of the company, the courts, guided by the South African decision of Gradwell Pty Ltd v Rostra Printers Ltd developed the notion of the financial impoverishment test in interpreting and applying s 67. In effect, s 67 would be infringed where the company diminished, directly or indirectly, its financial resources, including future resources in connection with an acquisition by a person of its own shares.

Section 67 was considered to be exceptionally widely drawn and proved to be far from easy to interpret and apply. Difficulties arose with its definition, determination and consequences of its breach.

by its memorandum of association to a person to enable him to buy its shares, and that the later was illegal independent of s 45. The problem whether s 45 of the English Act avoided a security by a company for the purchase of its own shares came up for decision in Victor Battery Co v Curry’s Ltd & Ors (1946) 1 All ER 519; that a security given by the company to secure a loan made to finance the purchase was not avoided. Contra. Dressy Frocks, (Ibid).

Another policy reason for enacting ss 45(1) and 148 was to prevent unauthorised reductions of capital and to protect creditors against a weakening of the company’s resources by indirect means.

Refer to Re VGM Holdings [1942] 1 All ER 225 and the loopholes identified therein.

(1959)4 SA 419. There, the South African Court in interpreting s 86bis (2) of its Companies Act 1926 (as amended), held that a transaction constitutes financial assistance if the company carrying out the transaction would have become ‘poorer’ as a result. (A detail explanation of this theory is available below in section 4.3.4 of this chapter).

The impoverishment test was adopted and elaborated upon in Burton v Palmer [1980] 2 NSWLR 878 at 881. There, Hutley JA declared:

The ways in which a company can infringe s 67 of the UCA 1961 are infinitely various but the essence of the matter is clear, has the company diminished its financial resources, including future resources, in connection with the sale and purchase of its shares. As the reduction may be indirect, it is not to be determined by considering only what is done by the parties to the transaction. Others may acquire rights against the company which diminish its resources in connection with the transaction and thus bring the section into play. The question is what is the impact upon the company of what took place, it being borne in mind that the assumption by a company of obligations even if it is unlikely that they may have to be honoured, diminishes its resources.

The decision in this and other cases to be seen later, and the policy reason behind the enactment of s 67, lead to what has been referred to as the ‘impoverishment’ theory. This theory (test) has been widely debated mostly in Australia and South Africa by the judiciary and some legal writers. (See, below section 4.3.4 for a detail analysis).

See, for example, Dressy Frocks Pty Ltd v Bock [1951]51 SR (NSW) 390. Similarly see also Mudge v Wolstenholme [1965] VR 707; Rich Investment Property v Calderon [1964] NSWRL 709. Compare the above cases with the English decisions in Victor Battery Co v Curry’s Ltd (1946) 1 All ER 519; Spink v Spink [1936]Ch
Although s 67 no longer regarded transactions in breach of the provision to be void it may be questioned how a transaction which is considered illegal is not also regarded as void. By implication, the common law on illegal contracts renders such transactions void. The courts have further interpreted s 67 to the effect that, money paid or property transferred is irrecoverable by the parties since they are all parties to the wrong. Usually, the company could not recover a loan. This provision seems to be undesirable in the sense that if its objective is to protect creditors and shareholders against improper diminution of the company's assets, it is questionable why the company should not recover although the interest of innocent third parties may become involved preventing the company from recovering.

In recognition of the short-comings of the liability provisions in s 67, the Eggleston Committee recommended that the law be changed. The Committee pointed out that if the object of s 67 is to protect minority shareholders and creditors of the company, it does not seem sensible to impose a penalty on the company itself, as distinct from the other officers responsible.

544. These cases go a long way to prove how difficult it is to discern and construe the financial assistance prohibition and the consequences of its breach. For excellence, in Victor Battery, Roxburg I held that a debenture given by a company as security for moneys lent to enable a person to purchase shares in the company was not illegal and void and therefore, not in breach of s 45 of 1929 Act (UK). The reasoning and conclusion of the Judge in this case has been questioned in most Australian decisions, in Dressy Frock (Ibid), E.H. Dey Pty v Dey [1966] VR 464 at 469; where the courts there find it difficult to follow the English authority but, rather the view that a breach of s 67 no longer renders financial assistance void but illegal. The complexity of the decisions in these cases is somewhat abstruse. The solution to the problem of these early authorities is undoubtedly cumbersome. For detailed analysis of s 67, see the works of: D. E. Harding, "Section 67 of the Companies Act – Present and Proposed Law" (1978) 10 Comm Law Assoc Bull 1 at 2; R. Barrett, "Financial assistance and share acquisitions" (1974) 48 ALJ 6; K. B.H. McPherson, "The prohibition against financial assistance for the purchase of shares" (1970-74) 7(8) U Melb L J 24.

53 Refer also, to Yam Ltd v McDonald Industries Ltd [1970] 3 NSWLR 3.

54 Some of the civil consequences of the prohibition have been the subject of discussion. To this extent see, R. Baxt, "...Void or Illegal contracts" [1975] U Tas LR 174.

55 See, Dressy Frock, above n 75.

56 It should be noted that the companies may recover against directors and officers for misuse as was the case in Seen v Law (1964) 287 (PC) or, against third parties under the principles on the liability of constructive trustees: Consul Development v DPC Estates (1975) 49 ALJR 74 at 85.

57 Australian Company Law Advisory Committee (Eggleston Committee), Fifth Interim Report (Canberra: Gov't Printer, 1970) para 94.

58 Ibid. The penalty has been regarded by some courts as inadequate. Thus, Lord Denning had spoken initially in the English case of Wallerstein v Moir, above n 3 that the penalty prescribed in the UK was less and not a strong deterrent. (at 239). Section 67(3) prescribes a penal sanction to both the company and officers in default, to be guilty of an offence ranging from an imprisonment for three months or a $1000 fine. This penalty which is at least moderate comparable to the £100 in the original legislation, is yet not an adequate deterrent.
Chapter 4  

4.2. History of Legislation (Australia)

This suggestion was taken up in April 1977 by the Interstate Corporate Affairs Commission (ICAC). With guidance obtained from the Lawrence Committee Report (Canada), ICAC recommended that companies be authorised to buy-back their shares and to be able to financially assist persons to purchase their own shares. These proposals were criticized by Professor Harding and were not implemented. In 1981, the Campbell Committee recommended that companies be allowed to acquire their own shares and financially assist members to purchase their own shares. However, the proposals were not immediately implemented. Section 129(1) of the Companies Code 1981 was enacted, which incorporated the s 67 ban on financial assistance but with some additions which were significantly different from the previous Act.

Consistent with the recommendations of the UK Jenkins Committee Report, and partly in the Eggleston and ICAC proposals; and also in reports pursuant to special investigations (such as the Report of the Inspectors into the Affairs of the Murumber Oil N.L), s 129 expanded s 67 by making it clear that, financial assistance would apply whether the acquisition occurred before or at the same time as the giving of the assistance, or whether

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79 Australian Interstate Corporate Affairs Commission (ICAC) Discussion Paper (1977) para 5.3. Some of the reasons the Committee gave for reviewing s 67 were that; it was unsatisfactory and too restrictive in scope. For example, it was uncertain whether s 67 applied to the acquisition of equitable interests in and options over shares. Moreover, as Austin noted in (ed), Austin Vann, The Law of Public Company Finance (1986)199-201, there was some doubt as to whether s 67(1) applied to financial assistance extended by the company after the purchase or subscription of shares. (See Dicta in Industrial Equity Ltd v Toepar [1972] 2 NSWLR 505). Gower, in one of his early editions, remarked that s 67 'is an unsuccessful attempt' to curtail the malpractice which gave rise to its enactment. (L.C.B. Gower, The Principles of Modern Company Law (London: Stephens & Sons, 1969) at 113). The Jenkins Committee considered that 'the section (s 54 of the UK equivalent) has proved to be an occasional embarrassment to the honest without being a serious inconvenience to the unscrupulous' (Jenkins Report (1962) para 176). Moreover, in Skelton v South Auckland Blue Metals Ltd [1969] NZLR 955 at 958, Woodhouse 4 said the general purpose of s 67 is, in fact, 'to avoid unauthorised reductions in the capital of a company and to protect interests of the creditors and contributories...the company itself is not the object of the protection created by the section'.

80 ICAC (ibid) para 5.3. The proposals of ICAC were in line with the Jenkins Committee approach.

81 See, note 72 above.

82 The Committee of Inquiry into Australian Systems (Campbell Committee)(1981) paras 21.93-21.99 at 78-80. (This Committee followed the opinions of the Greene Committee (UK)

83 Companies Act 1981 came into force on the 1st of July 1982. In general, s 129 expanded the exemptions of the financial assistance prohibition, a procedure for authorization of contemplated financial assistance was introduced, elaborate provisions were adopted to deal with the consequences of unlawful financial assistance to enable outsiders to rely on a certificate of compliance.
there was merely a proposed acquisition when the assistance was given.\textsuperscript{54} Section 129(1)(a) applied when a company directly or indirectly gave another party financial assistance to acquire relevant shares, by prohibiting a company from giving financial assistance in connection with the acquisition or units of shares in the company.\textsuperscript{55} These words prevented the device of interposing a company between the company whose shares were to be acquired and which gave the financial assistance on one hand and the recipient of the financial assistance on the other. Section 129(2) outlined various examples\textsuperscript{56} constituting financial assistance.

The Courts, in interpreting s 129(2), held in \textit{Burton v Palmer}\textsuperscript{57} that, a transaction by a company cannot constitute financial assistance unless the transaction involved some ‘actual or potential’ diminution of the financial resources of the company. Section 129(4) was inserted in order to require knowledge on the part of the company of the fact that financial assistance was given ‘in connection with’ the acquisition of the shares. This and the requirement of proof that the ‘purpose’ was a substantial purpose of the giving of the financial assistance were provisions designed to tighten up and limit the application of the prohibition in s 129(1).\textsuperscript{58}

\textsuperscript{54} Section 129 differ from s 67 in that new definitions of ‘purpose’ and ‘connection’ were inserted. Moreover while s 67 uses the word ‘purchase’, s 129 preferred the word ‘acquisition’.

\textsuperscript{55} Sections 129(1)(a) & (b)(i). Section 129(1)(c) prohibits a company from lending on the security of shares or units of shares in the company or in a holding company of the company.

\textsuperscript{56} These included the making of a loan, the giving of a guarantee, the provision of security, and the release of an obligation or the forgiving of a debt. These five transactions specifically referred to could be financial assistance per se and other types of financial assistance are only financial assistance if they give financial assistance in fact. (Refer to R.I. Barrett, (1974) 48 ALJ 6). Alternatively, a transaction is not caught by the section irrespective of whether it is one of the specific transactions, unless that transaction does give financial assistance. The latter alternative is more consistent with the literal wording of the section. This view, receives support from the bare reference in s 129(1) to ‘financial assistance’ which is elaborated upon in s 129(2) as contrasted with the position in the former s 67 where the specific types of financial assistance enumerated followed immediately upon the first reference to financial assistance. The former cannot be justified as it does not explain why the specified transactions inherently carry a greater risk of abuse than, say, the purchase of an asset or the declaration of dividend.

\textsuperscript{57} [1980] NSWLR 878 at 881 per Hutley JA. The ‘financial impoverishment’ theory was the determinant factor as to whether s 129 has been contravened.

\textsuperscript{58} Arguably, the course of legislation in the UK and Australia on the issue of ‘purpose’, represents a ‘two edged sword’. Whereas in the UK, the phrase ‘in connection with’ was removed in the 1980 Act and not inserted in the 1981 Act, in Australia, it was preserved under s 129 of the 1981 Act presumably for a purpose which one might infer was to overcome the difficulty presented by the obligation to prove the ‘purpose’ of the company. As Kirby P remarked in \textit{Darwall v North Sydney Brick & Tiles Ltd (No 2)} (1989) 15 ACLR 262, the retention of the word in our legislation in the face of English decision to remove it suggests to my mind a deliberate decision in Australia to persist with a more stringent obligation affecting the company’s officers. It is also noteworthy that in the \textit{Darwall case}, Kirby P expressly stated that the purpose of the prohibition included the avoidance of manipulation of the value of shares by companies and their officers dealing in such shares.
Other significant reforms were made by ss 129(5) and 130. Section 129 (5), for example, stated that in any breach of the financial assistance provision, the company commits no criminal offence. This annulled former s 67 which made both the company and ‘officers’ criminally liable. Sections 129(5-6) were addressed to the officers and then only if the particular officer was ‘knowingly concerned’. Officers could face a penalty of up to $10,000 fine or imprisonment for two years or both. Moreover, s 130 expressly recognised that a contract or transaction for providing financial assistance was not invalidated because it contravenes s 129(10) but was voidable at the option of the company.99

Generally, s 129 attempted to protect the interests of creditors and shareholders. The section was novel for its stoic dedication to the preservation of the principle of capital maintenance—by ensuring that share capital was not eroded.90 Yet, the 1981 Code created a paradox by allowing for a reduction of capital in s 123. Whilst its policy was clear, it did not simply prohibit transactions that may prejudice creditors or members. Instead, blanket prohibitions were placed on ‘self-purchase’ and ‘financial assistance’.91 This approach flagrantly disregarded the benefits such transactions could secure for shareholder and creditors. Like the previous legislation, there were certain legislative problems with the construction of s 129, including some enduring difficulties about the civil consequences of breach and about the mechanics of the new authorisation procedure.

99 The main idea of s 129(10) was the passage of a special resolution which was enhanced by disclosure and advertising requirements placing onerous duties on directors to ensure that shareholders were fully informed about the details of the proposed transaction and its likely effect on the company before they voted. The effect of this shift in language may be taken to have addressed the issue of the illegal contract problem) that has bitted the former s 67 and the conflicting views expressed in cases such as Victor Battery, above n 75 Dressy Fracks, above n 75 & Shearer Transport Co Ltd v McGrath [1956] VLR 316 regarding the issues as to whether a transaction in breach of the prohibition was void, illegal and unenforceable. Sections 129(10) provided that any contract in breach of the financial assistance prohibitions is voidable at the option of the company. Arguably, the famous ‘rule in Foss v Harbottle’ (1843) 2 Hare 46, which provides that the proper complainant in respect of a wrong to the company is the company rather than its members may fairly be obviated by s 206(3) of the Corporations Law, which entitles members, directors etc to give a notice to a third party avoiding the contract in the name of the company.

90 See, for example, the courts interpretation of section 129(2) and the ‘impoverishment’ theory in Burton v Palmer above n 89. Cf Darwall v North Sydney, above n 88.

91 Section 129 however specifically lists permissible transactions (See, ss 129(8), (9-10). The Code recognizes that financial assistance can, if appropriate safeguards are met be permissible. This is believed to benefit the very classes of persons it aims to protect.
Consequently, s 129 was a target for amendment\textsuperscript{92} in an attempt to address some perceived loopholes relating to a drafting oversight.\textsuperscript{93} In particular, it was uncertain whether the prohibition might apply to an acquisition of the company’s shares which the company facilitated in a way which did not diminish the company’s resources or otherwise cause detriment to the company, its shareholders and creditors.\textsuperscript{94} This oversight in s 129, led to the enacted of ss 205-206 of the \textit{Corporations Law (CL)}.\textsuperscript{95}

Section 205 expanded the wording of s 129, no doubt with the intention of clarifying the section’s scope and meaning. However, it is far from clear that the intention was achieved. Importantly, s 205 retained the linking words ‘for the purpose of, or, in connection with’ but, expanded on the meaning of the links in separate subsections.\textsuperscript{96} Even having regard to their expanded meaning, it is hard to see how the words ‘for the purpose of’ can be satisfied in a case where the acquisition occurs before the financial assistance is provided. That, at any rate, was the conclusion reached by Young J in \textit{Tallgren Pty Ltd v Optus Commercial Pty Ltd}.\textsuperscript{97} Also unclear, is the question of what if the acquisition would not have occurred but for the knowledge that the company would financially assist the acquirer to meet its acquisition costs?\textsuperscript{98}

\textsuperscript{92} Although a target for amendment, s 129 remained virtually unaltered until 1998.
\textsuperscript{93} See, Ford et al, \textit{Ford’s Principles of Corporations Law, 12th} (ed), (Australia: Butterworth’s, 2005) para 24.670 at 1173, where they remarked: “With drafting that was ‘extensive and complicated’ and basic concepts that ‘were very unclear’, the financial assistance provisions were likely candidates for review when the Commonwealth introduced its Corporate Law Simplification Program in 1994”. The basic premise of the section has remained the same namely that a company shall not provide financial assistance for the purpose of, or in connection with, the acquisition of shares in itself. Furthermore, it could be added that like its predecessors, the section (129) has not defined financial assistance other than limiting its meaning to the examples and the ‘financial impoverishment test’.
\textsuperscript{94} Ibid at 1175.
\textsuperscript{95} \textit{Corporations Law}, s 205, fortified the prohibition against the acquisition of a corporation’s own shares under four types of activities embodied respectively as ss 205(1)(a-c): The first is a blanket prohibition upon companies providing financial assistance (s 205(1)(a)); the second is interpretative provisions (ss 205(2-4) & (16); thirdly, liability provisions (s 205(5)-(7) and lastly, extensive provisions permitting a company to provide financial assistance in strictly defined circumstances (ss 205(8)-10). Generally, the provisions of s 129 of the old law were retained. For an elaborate discussion of the provisions of s 205 of the CL, see Bena, Collier. “Giving Financial assistance in breach of s 205(1) (a) of the CL: What does it mean” (1994) 4 \textit{AJCL} 337.
\textsuperscript{96} Sections 205(3)-(4).
\textsuperscript{97} (1998) 16 ACLC 1,526, 1,532.
\textsuperscript{98} For the writer’s view on this, see, s 4.3.4.2. below relating to financial assistance and take-over financing.
Chapter 4

4.2 History of Legislation (Australia)

The provisions in s 205 while capturing to a material extent the former provisions, were interpreted similarly by the courts on the reliance of the ‘diminution of resources test’. It is frequently said that the purpose of s 205(1), and its predecessors, was to reinforce the doctrine of maintenance of capital. One can see this reflected even in some relatively recent authority.99 Case law exposed the difficulties of interpreting s 205 and the inconsistencies of applying the impoverishment test. In Darvall v North Sydney Brick & Tile Co Ltd (No 2),100 Kirby J stated:

For my own part. I am not at all convinced that it is necessary in every case, in order to establish the giving of financial assistance that there has been as actual diminution in the company’s resources. The wide definition in s 129(2), now s 205 does not seem to me to require this.101

As a result of the Tallglen Case and, drafting oversights and basic concepts which were unclear in s 205 and the previous statute, the Government, directed the Corporations Law Simplification Task Force in 1994, to open up a discussion on the issue of whether companies should be permitted to provide financial assistance to members for the purchase of their own shares. The Simplification Task Force introduced its proposals in the draft Second Corporate Law Simplification Bill 1996.102 Following a change of government, the provisions reappeared, with minor changes, in the Company Law Review Bill 1997.103 These proposals initiated were enacted as Pt 21.3; ss 260A-260D of the Company Law Review Act (CLRA) 1998,104 and consolidated under the Corporations Act.105

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100 (1989) 15 ACLR 262. Cf Burton v Palmer [1980] 2 NSWLJ 878. See also, Jupiter Pty Ltd v Grauser (1983) 8 ACLR 212; The Burton case formula was doubted in Re An Application by National Mutual Royal Bank Ltd (1990) 8 ALC 1057 at 1064. These cases portray the complexity of construing s 205 and applying the impoverishment test.

101 (1989) 15 ACLR 262 at 263.

102 Attorney General’s Department: “Task Force Plan of Action” (Dec. 1993); Corporations Law Simplification Program: First Company Law Simplification Bill—Exposure Draft (July 1994) Schs 1-2; Simplification Program—Share Capital Rules—Proposals for Simplification (Nov. 1994) Canberra. In their series of proposals and recommendations, the Task Force recommended that ss 205 and 206 of the Corporations Law be repealed on the reasoning that many of the rules on financial assistance were too complicated which helped to add to the already transaction costs, thereby, preventing companies moving quickly enough to exploit commercial opportunities. (See, Task Force, “Share Capital Proposals: Current Approach—Complicated and Confusing” (1996) at 1-2 & 10. It is also to be noted that the Task Force made general proposals with respect to the simplification and deregulation of share capital rules the central aspect of its proposed changes reflecting a shift from rules of maintenance of capital to rules of asset maintenance.

4.3. **A Comparative Amelioration-The Current Australian Law**

4.3.1. **Section 260A (1) and the Materially Prejudice Provision.**

Under s 260A(1)(a), a company may financially assist a person to acquire shares (or units of shares) in the company or a holding company if giving the assistance does not involve ‘material prejudice’ to the interests of shareholders, the company or of the company’s capacity to pay its creditors. The meaning of ‘material prejudice’ is the key to the new provision. The Explanatory Memorandum recognized that for transactions which do not involve material prejudice, the new rules will make it unnecessary to decide whether the transaction involves the giving of financial assistance, but did not attempt to define the

...The prohibition performs a useful function in deterring a range of undesirable transactions having the potential to prejudice a company’s financial position. However, it impedes many normal commercial transactions. The Bill therefore prevents a company giving financial assistance to a person to acquire shares or unit of shares, in the company or a holding company if the transaction would materially prejudice the company’s ability to pay its creditors (Bill s 260A(1)(b)). This is subject to the exception that a company will be able to give financial assistance if the transaction has been approved by the company’s shareholders in the manner set out in s 260B. This approach is intended to minimise the difficulties that the rule currently causes for ordinary commercial transactions. In particular, for transactions which do not involve material prejudice, the new rules will make it unnecessary to decide whether a transaction involves the giving of financial assistance. The new rules will bring the requirements for financial assistance more closely into line with those proposed for capital reduction...

The law currently contains a range of exceptions to the prohibition that relate to financial assistance given in the ordinary course of money lending business (current s 205(8) & (9)). These provisions will be preserved (Bill s 260C).

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184. *Company Law Review Act* (CLRA) (1998) (Cth). Assented to on the 1st July 1998. While this law recognises and permits financial assistance in accordance with specific guidelines and requirements, it also contains some exceptions, the extent of these are more limited than previous provisions. This is not the least to imply that the current provisions are ‘problem free’ for, in attempting to simplify the law, many technical words were added which stop short of explicit judicial and legislative explanations. (See for example, the meaning of ‘materiality prejudice’: the role of s 260B—the shareholder resolution provision which is aligned with the capital reduction requirements). See in general some commentators viewpoint on the current law: Ford et al, above n 93 at para 24.710; Lipton & Herzberg, *Understanding Company Law* 11th (ed), (Sydney: LBC Information Services:2003) at 181; R. Tomsas, S. Bottunley, R. McQueen, *Corporations Law in Australia* 2nd (ed) (Sydney: Federation Press, 2002) 476-484; J. Hambrock, “Shares”, in (ed) *Australian Corporations Law: Theory and Practice, Vol 1* (Australia: Butterworth’s, 2004) at 2.6.0425. For an analysis of current law see, K. Fletcher, “Re-baiting the Financial Assistance Trap” (2001) 11 A/JCL 424.


186. In comparison, s 152(2) and s 154 (2) of the *Company Act 1983*(UK), uses the word, ‘materiality or materiality’ test in interpreting financial assistance under that legislation. There, financial assistance is deemed to cover two situations. The first is where the company providing the financial assistance has net assets. (Net assets, means the aggregate of the company’s assets less the aggregate of its liabilities: s 152(2)). In this case, the transaction or any act of the assisting company is only caught where the act reduces those assets to a material extent. The second situation is where a company has no net assets. Here, any form of financial assistance, is caught. The ‘materiality’ test is open to at least two distinct interpretations. One approach is to focus on the size of the reduction in percentage terms and to regard it as immaterial if it falls below a certain minimum threshold. The other approach is to look at the total amount involved and to regard it as immaterial if it is large, even if it represents a tiny reduction in the company’s net assets based on a percentage test. (see, Parlett v Guppy’s (Bridport) Ltd [1996] BCC 299 CA 308.
Chapter 4  

4.3. Comparative Amelioration (Material Prejudice)

Though there are no specific rules in determining material prejudice, the Explanatory Memorandum said:

Whether a particular transaction involves a material prejudice, and therefore requires shareholder approval, will be a question of fact to be answered in light of the circumstances of each case. For example, material prejudice to the company, its shareholders and the company’s ability to pay its creditors may occur if a company withdraws a large amount of money from its bank and lends it to a company that is bordering on insolvency, or if it guarantees a loan to a company that is likely to default. In particular it will not be possible to determine whether the transaction involves material prejudice merely by reference to arbitrary rules, such as the percentage impact the transaction will have on the company’s profit.

In relation to the question of what constitutes material prejudice in the similarly worded s 256B(1)(b), Young J in Re Bidvest Australia Ltd observed that there are considerable problems in the definition of what are the interests of the company or its members which are not to be materially prejudiced. While the examples given by the Explanatory Memorandum, are relatively clear, there are other areas of difficulty in the construction of that phrase. In so far as the idea of material prejudice directs attention to the effect of the financial assistance on the company’s financial situation, can this be interpreted as a statutory endorsement of the impoverishment test? Also questionable, is that unlike in s 256B(1)(a) and s 232(d) where the legislature uses the words ‘interests of the shareholders as a whole’, under s 260A(1)(a), it uses the ‘interests of the company and its shareholders’. Does this suggest that material prejudice to any member will suffice to breach the section? Moreover, it is noted that s 260A (1) does not indicate the time frame within which the prejudice is to be assessed.

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108 Explanatory Memorandum to the Company’s Law Review Act 1998, (1998) para 12.77. The Explanatory Memorandum suggest that shareholder approval would be required where a company proposes to provide financial assistance for the purchase of its shares.


110 See, Tomasic et al, above n 104 at 482.

111 Section 260A (2) states that without limiting subsection (1), financial assistance may be given before or after the acquisition of shares (or units of shares); and take the form of paying a dividend.
Par excellence, will the risk of material prejudice to shareholders’ interests in the short term satisfy the test, even where there are good prospects for long term improvements in their position?\textsuperscript{112} Section 260A seems to equate the material prejudice with a diminution in the company’s financial resources, (i.e., if the financial assistance would lead to a company’s resources being diminished or reduced in value). For instance, if the purchaser of the company’s shares has no substantial assets and finances the entire purchase price by an unsecured interest free loan out of the company’s cash reserves, the material prejudice test is likely to be triggered even where the amount of the loan is relatively small compared with the value of shareholders’ funds-in the sense that it leads to the diminution of the company’s resources. Since the company’s ability to pay its creditors must be taken into account, as well as the interests of the company and its shareholders, the quantitative assessment must have regard to the impact of the transaction on assets (i.e., a company’s balance sheet). Also, future profitability which affects the interests of shareholders and future cash flow which affects the ability to pay creditors are all relevant factors to be considered in determining ‘material prejudice’.\textsuperscript{113}

In \textit{Re HIH Insurance Ltd; ASIC v Adler},\textsuperscript{114} a company made an undocumented and unsecured payment of $10million to a company (PEE) controlled by one of its directors (Adler). PEE was the trustee of AEUT Trust. Nearly $4million of this sum was used by PEE, as trustee, to acquire shares in HIHC holdings on the stock market. HIHC subsequently acquired an entitlement to 90% of the AEUT Trust’s distributable income. PEE as trustee, suffered a loss on all of these investments amounting to $2million. Santow J saw s 260A as inviting the court to take a commercial approach, assessing material prejudice by looking at all interlocking elements in the commercial transaction as a whole, as Hoffmann J did in \textit{Charterhouse Investment Trust Ltd v Tempest Diesels Ltd}.\textsuperscript{115} In \textit{ASIC v Adler}, Santow J said:

\begin{quote}
...one assesses material prejudice by reference to the transaction with its interlocking elements giving rise to the financial assistance, taking into account its financial consequences for the
\end{quote}

\textsuperscript{112} This argument is consistent with Tomasic at al, above n 104.
\textsuperscript{113} See Ford et al, above n 93 para 24.710 at 1180.
\textsuperscript{114} (2002) 41 ACSR 72.
\textsuperscript{115} [1986] BCLC 1.
interests of the company or its shareholders. This is in order to determine where the net balance of financial advantage lies from the giving of the financial assistance.\textsuperscript{116}

On appeal in Adler v ASIC; Williams v ASIC,\textsuperscript{117} Giles JA endorsed Santow J’s view that where financial assistance is provided by a company within s 260A (1) (a) the onus is on those supporting the transaction to show that it was not materially prejudicial to the interests referred to in s 260A (1) (a). Another problem in the application of the material prejudice test arises where the acquisition of shares transfers control of the company which might have otherwise occurred. As Ford et al, questioned, to what extent is it relevant, in considering material prejudice, to investigate whether a change in control is likely to benefit or harm the shareholders? Does the interest of the shareholders include the interests of the controlling shareholders as such or a former controller or a thwarted would be controller?\textsuperscript{118}

Presumably, and with some hesitation, the material prejudice to the interests of the company and its shareholders of which s 260A (1) (a)\textsuperscript{119} speaks may be related to the prejudice to the company’s present and financial position and the position of the shareholders in their capacity as shareholders, rather than in their capacity as actual or potential controllers.\textsuperscript{120} The significance of the transaction in terms of corporate control is left for ASIC to assess in the context of an application to the Takeovers Panel.\textsuperscript{121} The general notion of s 260A(1)(a) is that some transactions are objectionable even if their impact on the company’s financial position is slight in percentage terms, while other

\textsuperscript{116} (2002) 41 ACSR 72 at 158.
\textsuperscript{117} [2003] NSWLR 131 at 368.
\textsuperscript{118} Ford et al, above n 93 at 1181.
\textsuperscript{119} Section 260IB which deals with the shareholder and disclosure procedures has already been canvassed in Chapters 2 and 3 where the procedures are similarly worded. It is important to note that s 260B is designed to provide an exception to the primary rule, stated in s 260A(1), to the effect that, where directors are not satisfied that the giving of financial assistance will not materially prejudice the company, its members or creditors, they may elect to seek shareholder approval of the transaction. Ironically, a dividend payment that could materially prejudice the interests of creditors the company and shareholders would have to be approved by shareholders. It is unclear why shareholders who are the recipients of dividends should also be those to make decisions which are in the interests of creditors. Apart from the disclosure of information in the ASIC Alert System, the safeguard provided by s 260B is doubtful. Doubtful in the sense that it is not reasonable to trust shareholders to make decisions which are in the interest of creditors. It would have been more appropriate if the law was drafted in a way that creditors have a say in any resolution that affects their interest and to be formally notified.
\textsuperscript{120} This is consistent with Ford et al, above n 93; J. Hambrock, above n 104 para 24.0435 at 26.367.
\textsuperscript{121} See, s 732(1) (d).
transactions are unobjectionable unless their percentage impact on the company’s financial position is large. A literal interpretation suggests that directors should consider that the material prejudice test is triggered when it is shown that failure of a proposed financial assistance transaction would result in the company being unable to pay its debts as and when they become due and payable or being unable to maintain its dividends to shareholders. Compared with the English approach, Australian interpretation of materiality is more accommodating, because, its looks at the impact on the company’s financial resources, and the effect that it will have on its corporators. It is also suggested that, s 260A(1)(a) should also be interpreted to accommodate the interests of the ‘shareholders as a whole’ as found under ss 232(d), so that, material prejudice to any creditor or shareholder suffices to trigger the provision.

4.3.2. The section 260C Exemptions & the Question of Dividend Distribution.

A number of transactions which are exempted from the operation of s 260A are listed in section 260C. Accordingly, s 260C(5), exempts other transactions affecting share capital such as, reduction of capital and share buy-back from the operation of s 260A(1) but not dividend distribution. The questions is, if s 260A does not apply to any financial assistance which is given as a result of a share buy-back and reduction of capital, why no exemption for dividends? Section 260A (2) (b) provides that financial assistance may take the form of paying a dividend (meaning that dividend payments fall within the ambit of s 260A). Perhaps, dividend payments are not exempted from the operation of s 260A on the reasoning that it would be necessary to avoid other deeming provisions which would otherwise cause a company to contravene the section whenever it paid a dividend.

These transactions cover situations not commercially unobjectionable such as; acquisition or creation by a company of a lien on its partly paid shares for an amount payable to the company on those shares; (s 260C(1)(a)); agreement between a company and subscriber for payment of shares by installments (s 260C(1)(b)); provision of financial assistance as a company’s ordinary business (s 260C(2)); guarantee or security provided by a subsidiary company of a borrower (s 260C(3)); financial assistance given under an employee share scheme (s 260C(4)); reductions of capital and share buy-backs (s 260C(5)(a & b)); purchase by a company of its shares pursuant to a court order (s 260C(5)(c)) and discharge of an ordinary company liability (s 260C(5)(d)). The writer’s argument is centrally focus on the question why there is no exemption for dividend distribution. This is because, the issue has been controversial. The English Company’s Act, s 153(3) also lists a number of specific matters which are not within the scope of the ban. This list is largely for the avoidance of doubts (Refer, to Standing Committee A, Hansard, Session 1980-1981 (30 June 1981) col 301).
to a member, knowing that the member might use moneys received to purchase its shares. Although it may be inferred that s 260C(5) exempts a dividends paid on ‘ordinary commercial terms’ of a liability that the company incurred as a result of its business dealings, however, that section lack precise meaning because of the divergence between legal and accounting views on the meaning of ‘ordinary commercial dealings’. 123

It can be difficult to understand why the declaration or payment of a dividend should fall within the ambit of s 260A (1). Dividend payments are not normally taken to be financial assistance because they must be paid out of profits and they are usually paid pursuant to provisions of a company’s constitution.124 Also, former s 205(8) of the Corporations Law provided that the prohibition of financial assistance did not apply to dividend payments made in good faith and in the ordinary course of commercial dealings. In Milburn v Pivot Ltd,125 a dividend payment was taken to constitute the provision of unlawful financial assistance if it was paid for the purpose of, or in connection with, an acquisition of shares in the company. In such circumstances, the dividend could not have been said to have been paid in good faith or in the ordinary course of commercial dealing.

At general law, as shown in the New Zealand case of Re Wellington Publishing Co Ltd,126 the payment of dividends out of a company’s profits will not normally constitute the provision of financial assistance because they are usually paid pursuant to a provision in the company’s constitution. Under a comparative jurisdiction, s 153(3) (a) of the English Company’s Act 1985 which lays down the pre-conditions which must be fulfilled before a company can begin to embark on providing financial assistance, provides that the financial assistance may only be given if the company has net assets which are not thereby reduced or, to the extent that they are reduced, if the assistance is provided out of distributable

123 In Chapter 5 of this thesis, it was seen that the law of dividends permits companies to make distributions that Accounting principles would not consider to be ordinary commercial dealings. For example, distribution of current revenue profits without making good previous years revenue losses; distribution based on an unrealized accretion to profits.


125 (1997) 115 ACLC 1520 at 1546 per Goldberg J.

126 (1973) 1 NZLR 133. See, also, Rosfield Group Operations Ltd v Austral Group Ltd (1981) 5 ACLR 290 at 296 per Connolly J.
profits. The English legislation puts it beyond doubt that, a distribution of a company’s assets by way of dividends lawfully made (or a distribution made in the course of the company’s winding-up) is not prohibited by financial assistance law.

Although the sudden emptying of the company’s cash box through say an extraordinary dividend for the purpose of putting its recipients in funds to re-finance the company’s takeover could be sufficient to remove dividends from the s 260A(1) financial assistance exemption, a strong line of authority suggests that if a dividend is lawfully sourced and does not infringe on ‘necessary capital’, it will not constitute financial assistance, even though the sole purpose of a dividend is to fund a relevant acquisition. In Re Wellington, the court sought a declaration that its proposal to have a newly acquired company declare a dividend sufficient to recover its purchase price did not contravene the equivalent New Zealand prohibition. Quillam J doubted that a dividend payment would ever infringe the financial assistance legislation. He said:

The payment of a dividend is part of the normal functions of a company ... it is probably as much the reason of the company’s existence as is the earnings of profits the reason for an individual trader being in business. A dividend must be regarded as a return on investment ... the payment ... of a dividend ... is not to be regarded as giving financial assistance to that shareholder....

There, Quillam J emphasized the need to protect both minority shareholders and creditors. His Honour reasoned that the dividend was declared out of distributable profits and the purchase price was found not to have been influenced by a belief that the bidder company may be able to use the dividend payment. Re Wellington was subsequently cited with approval in Rossfield Group Operation Pty Ltd v Austral Group Ltd. Rossfield declared a dividend payment in the face of an acquisition. In so doing, it extended the dicta of Re Willington that the proposal was an ‘ordinary commercial dealing,’ despite the objection of the minority shareholders and despite the fact the purchase price was

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128 See, Milburn v Pivot, above n 126; Re Wellington Publishing, above n 123.
influenced by a belief that the bidder company would use the dividend payment to meet the share purchase price. Yet, the company was buoyant and dividends were to be paid from revenue reserves. Connolly J said:

...I should say immediately that I have great difficulty regarding the declaration of a dividend as the giving of financial assistance. It is of the nature of a share or stock unit that dividends are paid from time to time upon it. 131

His Honour found the dicta of *Re Wellington* consistent with the policy of the law. Arguably, the better view is that a dividend payment out of distributable profits cannot be regarded as contravening s 260A (1). Although s 260C (5) exempts a dividend payment made on ordinary commercial terms, the section might be of little value, because the dividends falling within the ambit of s 260A (1) do not infringe the section in the first place. Irrespective of the merits of this argument, the s 260C(5) true value is that it shows that the legislature is prepared to acknowledge the *Trevor* doctrine’s warning, whist legislating in a spirit so permitting ordinary commercial transactions that might be caught by the prohibition. It is submitted that all of the various matters under the exemption provisions that are regulated by other provisions of the *Corporations Act* including dividend distribution, are justifiable for their exclusion from the financial assistance prohibition. This would assist to avoid unnecessary duplication of regulation.

4.3.3. Consequences for breach of s 260A

Directors are placed under onerous duties to discharge their fiduciary duties and the duty of due diligence to make sure financial assistance complies with the relevant requirements. 132 If a company provides financial assistance in contravention of s 260A, the contravention does not affect the validity of the financial assistance or of any contract or transaction with it; and the company is not guilty of an offence. 133 Persons who are involved in the breach of s 260A contravene the civil penalty provisions and commit a criminal offence where the contravention was tainted with dishonesty. 134

131 Ibid at 296.
132 Section 260E.
133 Section 260D(1)(a-b).
Chapter 4  

4.3. Comparative Amelioration (Consequences)

A person is said to have breached s 260A if by act or omission, directly or indirectly, knowingly concerned in, or party to, or conspired with others to effect the contravention. The difficult question is how and when is it possible to impute knowledge on a person for breaching the law? What is also unclear is the question of whether a related party or non-related party who is an innocent recipient of a financial assistance is to be liable for breach of the financial assistance provision where he/she was not a party to the transaction. In *Independent Steels Pty Ltd v Ryan*, Fullagar J opined that a company may contravene s 260A by providing financial assistance to a person who did not need or want it. In *Yorke v Lucas*, the court held that to make a person liable as an accessory, it is necessary to show that the person had intentionally participated in the contravention. A person must be shown to have had knowledge of the essential aspects of the offence in order to be said to have intentionally participated in it. Knowledge in this context means actual (rather than constructive) knowledge. In *Pereira v DPP*, the High Court said:

> It is never the case that something less than knowledge may be treated as satisfying a requirement of actual knowledge. [T]he question is that of the knowledge of the accused and not that which might be postulated of a hypothetical person in the position of the accused, although, of course, that may not be an irrelevant consideration...[W]here knowledge is inferred from the circumstances surrounding the commission of the alleged offence, knowledge must be the only rational reference.

Since it is the company who carries the burden of bringing the transaction within s 260A (1) (a-c) by way of defence, a person may be held to involved in the breach without the prosecution establishing that the person had actual knowledge that, for example, the transaction was in fact materially prejudicial to the interests of the company or its shareholders. Section 260D has the effect of validating the transaction though it was in breach of s 260A. The policy inherent in s 260D as illustrated in *Baioka Pty Ltd v*

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134 Section 260D(3).
135 See, section 79.
Jackson\(^{140}\) is that the transaction stands providing certainty and protection for the interests of third parties. Where a creditor or shareholder senses that his interests may be threatened by the proposal to provide financial assistance they can seek injunctive relief under s 1324 only when a contravention of s 260A is threatened but not after the financial assistance has been improvidently implemented.\(^{141}\) Equally, creditors can invoke the s 588G provision which deals with director’s liability for insolvent trading.\(^{142}\)

4.3.4. Some Definitional & Policy Issues.

This section of the study considers some policy problems underpinning the financial assistance regime which amongst others, raises question as to the meaning of financial assistance, the policy problem of a successful offeror using the target’s assets to discharge its takeover related liabilities and the debate surrounding the ‘financial impoverishment’ test.

4.3.4.1. Problems of Defining & Determining Financial Assistance.

Neither s 260A (1) nor the Corporations Act make any attempt to define ‘financial assistance’ except to indicate that it may take the form of paying a dividend.\(^ {143}\) Judicial attempts to provide a meaning produce conflicting dicta.\(^ {144}\) Efforts to interpret financial assistance under the predecessors of s 260A produced two schools of thought. The broad view (‘purpose theory’) was that a company would be taken to give financial assistance if the only purpose of the company, in entering into a relevant transaction, was to give someone the financial means to acquire the company’s shares. On this view, a company

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\(^{141}\) (1998) 30 ACSR 67 per Hansen J. See also, Explanatory Memorandum, above n 110 para 12.86.

\(^{142}\) See, Rataoka Pty Ltd (ibid). This is consistent with the position under s 256 in relation to improper reduction of share capital (see, e.g., Winpar Holdings Ltd v Goldfields Kalgoorlie Ltd (2002) 20 ACLC 265.

\(^{143}\) See, section 4.3.4.2. below, where the directors’ duties and insolvent trading provisions are advanced.

\(^{144}\) Section 260A(2)(b).

Case law on predecessors and counterparts of s 260A, for example, provided that financial assistance can constitute loans, (DJE Constructions Pty Ltd v Maddocks [1982] 1 NSWLR 5); the making of a gift (Re FGM Holdings Ltd [1942] Ch 235); and something in the nature of aid or help (Sterile Air Pty Ltd v Papullo (1998) 29 ACSR 46). Also, regard must be had to its commercial substance rather than its form (Independent Steels Pty Ltd v Ryan [1990] VR 247 at 251; Charterhouse Investment Trust Ltd v Tempest Diesels Ltd [1986] BCLC 1 at 1; financial assistance does not have to take the form of monetary assistance (Milburn v Pivot (1997) 15 ACLC 1520 at 1552 per Goldberg J).
could act improperly even if there was no actual diminution of its resources. The alternative view (otherwise known as the narrow view or the ‘impoverishment theory’) was that there could be no improper giving of financial assistance unless the company had a net transfer of value, in connection with the acquisition by someone of its shares or the shares of its holding company. The second version of the narrow view is the material prejudice test under s 260A, which is interpreted as indicating that the provision can only be contravened if there has been an actual diminution of the company’s assets, materially prejudicial to the interests of the company, or its shareholders or its ability to pay its creditors.

4.3.4.1.1. The Narrower View (‘The Impoverishment’ Theory).

The impoverishment theory which is said to derive orthodoxy from the passage of Hutley JA in Burton v Palmer involved the giving of certain warranties by the company to a prospective shareholder. It was argued before the court that these warranties amounted to the giving of financial assistance within the meaning of s 67(1) of the Companies Act 1961 and that, accordingly, the purchase of shares was void, although the two main judgments used different arguments. The Court of Appeal accepted the fact that the warranties assisted in the sale of the shares and had been given for that purpose. According to Hutley JA, the test for determining whether a transaction amounts to financial assistance is thus:

The ways in which a company infringes s 67 of the ‘UCA’ 1961 (now s 260A (1)) are infinitely various but, the essence of the matter is clear, has the company diminished its financial resources, including future resources in connection with the sale and purchase of its shares... [t]he issue is, what is the impact upon the company of what took place, it being borne in mind that the assumption by a company of obligation, even if it is unlikely that they may have to be honoured, diminishes its resources. (Emphasis added).

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146 For example, see, Burton v Palmer [1980] 2 NSWLR 878 at 881 per Hutley JA; R v Rogel (1992) 7 WAR 356 at 368; Wambo Mining Corp Pty Ltd v Wall Street (Holding) Pty Ltd (1998) 16 ALCR 1, 601 at 1, 607.
147 See, ASIC v Adler (2002) 41 ACSR 72 per Santow J. A detailed analysis of this approach is already canvassed in s 4.3.1 above.
149 [1980] 2 NSWLR 878 at 881. This approach became known as the ‘impoverishment theory (test)’ (based on the reasoning that a transaction does not constitute financial assistance unless it involves some actual or potential
Hutley JA intimated that, it is clear the covenants in some way assisted the sale of the shares otherwise they would not have been acquired. However, His Honour refused to hold that they amounted to financial assistance within the meaning of s 260A. He put it by stating:

[Warranty] 4 (j) provides: ‘That the respective Registers of members, directors and charges and all other books of the company required by law to be kept by it are properly kept’. The company's warranty that it has done what by law it is required to do does not give any financial assistance in connection with the transaction. It does not take over any of the responsibilities of the vendor or purchaser in their capacity of directors. It gives the vendor a claim for damages against the company which he did not have before, but where the vendor is cutting all connections with the company, I am unable to see this can give any more than a right of action for nominal damages. A creation of a right of action for nominal damages is not, in my opinion, the giving of financial assistance.150

His Honour, finally said:

...because the policy against the prohibition were to prevent unauthorized reduction of capital, detrimental alterations of the financial position of the company, prejudicial to the interests of creditors and shareholders, contravene the law. Where the transaction is commercially justifiable in the company’s interests, it cannot contravene the statutory prohibition.151

diminution of the financial resources of the company. The test applies even if there is no actual diminution but, any potential diminution suffices to breach the law). Hogson J, argued in Darwall v North Sydney (No 2) (1989) 15 ACLR 262 at 263, that test is a misnomer, because what the court considers is whether the resources of the company are diminished by the transaction. (See also, Talliglen Pty Ltd v Optus Communications Pty Ltd (1998) 16 ALC 1526 at 1533. This theory was originally formulated in a string of South African decisions. The proposition was that in deciding whether financial assistance has been given, the inquiry should be directed towards ascertaining whether the company has been made the poorer. (See, for example, Gradwell v Rotini Printers Ltd [1959] 4 SA 419 per Schreiner JA; Miller v Muller [1965] 4 SA 458; Bay Loan Investments Pty Ltd v Bay View (Pty) Ltd [1970] 2 SA 313; S v Hepker [1973] 1 SA 472. See, also, the discussion by R. C. Bouthin, “A New Test for Financial Assistance?” (1973) 90 SALJ 211. A similar view was taken in interpreting earlier Canadian Financial assistance legislation. See, British Columbia Red Cedar Shingle Co Ltd v Stolze [1932] 1 WWR 164 at 172-173 which chronicle the introduction of the impoverishment test thus: “… the diminution of capital must not be fanciful or theoretical, but actual and substantial, before the transaction can be successfully attacked” Also refer to, Berner, “Annual Survey of Canadian Law” (1975) 7 Ottawa LR 153.

150 Ibid. The financial impoverishment test was accepted and applied in Re Myer Retail Investments Pty Ltd (1983) 1 ALC 900 at 990; McEwan v Dick (1985) 3 ALC 671 at 678, but was questioned in a number of decisions. In Darwall v North Sydney Brick and Tile Co Ltd (1990) 8 ALC 1057 at 1064, McPherson SPJ argued that the absence of a diminution of financial resources does not necessarily mean that there has been no financial assistance within the meaning of s 260A. (See also, Jury v Vogt (1993) 10 ACSR 718). Similarly, in Dempster v NGSC (1993) 11 ALC 576, some transaction has taken place between the relevant parties. A question arose as to whether Rothwells (the company) had given financial assistance for the purposes of the proposed acquisition of its shares by Dempster holdings. Rothwells argued that because it had benefited from the loan transaction, by receiving funds from the sale of the bills, there was no impoverishment and no breach of the financial assistance prohibition. Malcolm CJ said:
The most which may be said about the impoverishment test is that it may provide some assistance in determining whether the transaction was a genuine commercial transaction. It may be relevant to the question of financial assistance and to the question of purpose, but, in my opinion it would not be decisive ...

151 Ibid at 880-881.
Similarly, Mahoney JA said:

... I do not think that the section operates to render illegal or invalid a transaction which involves an obligation which presently does not but may (in a possible factual) context not then existing and which does not eventuate) put the company in a position in which one of the alternative methods of discharging its obligation may constitute the giving of financial assistance. In the present case, the shares were never the subject of any obligation falling within the warranty, it was not suggested that there was any significant possibility that they would be, and they did not become the subject of any such obligation. I therefore do not think that what happened here fell within the section.\textsuperscript{152}

It is clear from the above extracts that the views of Hutley and Mahoney JJA were that there could be no financial assistance unless the company had made a net transfer of value, in connection with an acquisition by someone of its shares or shares of its holding company. The impoverishment test which is now reflected in s 260A prescribes that unless the transaction in question diminishes the resources of the company in some way, the company has not given financial assistance. In \textit{Burton v Palmer}, the New South Wales Court of Appeal ruled that an agreement by a company to pay a debt that was presently payable did not amount to financial assistance merely because the creditor made payment a condition of sale of his shareholding. The company’s resources were not diminished in connection with the sale of its shares. The company was merely meeting its pre-existing obligation, an obligation that was presently due and payable.

Another definitional difficulty was left for the courts to explain the meaning of the word ‘assistance’, and whether the financial assistance actually assists the person to acquire shares. In the \textit{Burton v Palmer} case, Mahoney JA held that:

The mere agreement of the company to pay its present indebtedness does not amount to financial assistance. The term ‘assistance’ in this context means the furnishing of something which is needed or, at the least which is wanted, in order that the transaction be carried out. The term has a meaning which is closer to need or want, it does not mean something which is merely co-operation.\textsuperscript{153}

\textsuperscript{152} Ibid at 890-891.
\textsuperscript{153} (1980) CLC 40 40-668 at 34.
While Mahoney JA equated ‘assistance’ with either ‘acting with another’ or ‘supplying a need’, the Full Federal Court equated the term, with the nature of help or aid. In *Independent Steels Pty Ltd v Ryan*, Fullagar J suggested that the words ‘need or want’ are not to be interpreted too narrowly. His Honour, stated that financial assistance might occur even in the case where the purchaser did not mind whether or not it was given the assistance. There, he specifically submitted that there can be assistance within s 260A where it appears that the company provided financial assistance with a purpose of financially assisting the acquirer, even where the acquirer did not ask for, and did not need help. In a similar interpretation of s 152(1)(a) of the English equivalent, Arden LJ held in *Chaston v SWP Group plc* that a transaction is considered financial assistance if the impugned transaction is actually capable of assisting the acquirer to obtain the shares. Whatever meaning is giving to the word ‘assistance’ the preferable meaning would be one that would contravene s 260A from a commercial perspective, that is, the assistance was materially prejudicial to the company and its various stakeholders.

Accordingly, because the rationale of s 260A is to protect creditors and shareholders against an unauthorized reduction of capital that may materially prejudice the interest of the company, or its shareholders or the company’s ability to pay its creditors, the impoverishment theory is consistent with the s 260A ‘material prejudice’ test. However, because it is ‘financial assistance’ itself that the legislation prohibits and because financial assistance does not always involve a diminishing of resources, the impoverishment test is relevant to material prejudice but not necessarily determinative of financial assistance.

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154 See, *Sterileaur Pty Ltd v Papallo* (1998) 29 AVSR 461. In *Barclays Bank plc v British and Commonwealth Holdings plc* [1995] BCC 1059 CA, the Court of Appeal held that the assistance has to be financial in nature and that it has to amount to help as opposed to mere co-operation. This view is consistent with that of Mahoney J in *Burton v Palmer*. (1989) 7 ACLC 804 at 811.


156 Section 260A(1)(a).

Chapter 4

4.3 Comparative Amelioration (Problem of Definition)

There are many circumstances where it will be quite clear that the company has not suffered any actual or potential diminution in its financial resources, and yet, it could hardly be doubted that financial assistance has been given.\textsuperscript{159}

4.3.4.1.2. The Broader View ("The Purpose" Theory).

It is difficult to reconcile the impoverishment theory with the English Court of Appeal decision in Belmont Finance Corporation Ltd v William Furniture Ltd (No 2), which supports the broader view or purpose theory.\textsuperscript{160} The relevant facts were that, a company bought an asset for a price which, it later turned, was grossly inflated and the vendors of the asset used the proceeds of the sale to buy the company. The Court of Appeal held that this was unlawful financial assistance. All members of the Court of Appeal agreed that it would have made no difference if the price which the company had paid had actually been a fair one because the company had acted without regard to its own commercial interests and with the sole purpose of putting the vendor of the assets in funds to acquire the shares. Clearly, it was not in the minds of the judges that a reduction in net assets was a necessary prerequisite of unlawful financial assistance. Belmont's directors genuinely believed the acquiring of shares in 'M Ltd' to be a good commercial proposition.

In the principal judgment, Buckley LJ Stated:

The purchase of the share capital of [M. Ltd] may have been intra vires of Belmont but it was certainly not a transaction in the ordinary course of Belmont's business or for the purposes of that business as it subsisted at the date of the agreement. It was an exceptional and artificial transaction and not in any sense an ordinary commercial transaction entered into for its own sake in the

\textsuperscript{159} Traditionally, a loan for the purpose of or in connection with a purchase of a company's shares would be considered to have breached the financial assistance prohibition. Cf Durack v Western Australia Executor & Trustee Co. (1944) 72 CLR 189, where the principle is that a loan by a company to a person to enable that person to become a shareholder does not worsen the financial position of the company but breaches the financial assistance prohibition. However, that may no longer be the situation since s 260A (1)(a) now permits financial assistance in such situations.

\textsuperscript{160} (1980) 1 All ER 393. (Noted at (1980) 54 ALR 552). The ruling in Belmont Finance caused a re-assessment of certain assumptions on which previous market practice had been based. This resulted not so much from the 'decision on its facts but from the court's views on what the position would have been if the transaction had been for full value This decision might surprise to many practitioners who would assume that the fairness of the price at which the transaction was done or the partially proper purpose which underlay it would suffice to take a transaction outside the prohibition. (See, R. Instone, "Section 54 and All That" [1980] BL 99). See, also, Brady v
commercial interests of Belmont...the agreement would have contravened [the relevant Act] even if
$500,000 was a fair price for M Ltd (Emphasis added).161

Similarly, in Charterhouse Investment Trust Ltd v Tempest Diesels Ltd,162 the relevant
transaction comprised the sale of shares in Tempest, and the surrender by Tempest to the
seller of the shares (its holding company) of certain tax losses. These tax losses could be
used by the holding company and thus represented potential deductions in determining
the taxable quantum in future corporate tax calculations. Tempest alleged the agreement
was unenforceable because the transfer of value to its holding company constituted the
giving of prohibited financial assistance. Hoffman J concluded that no prohibited
financial assistance had been given and, in so doing, he ascertained:

...The transaction, clearly constituted financial assistance being given to Tempest for the purpose
of putting it into a state in which (the buyer) would buy the shares, but did not involve Tempest
giving financial assistance to anyone.163

Hoffmann J cited Belmont Finance as authority that the prohibition was only infringed if
financial assistance was the only or main purpose of the transaction. His Honour, further
cited Belmont Finance as authority for the proposition that if the requisite purpose exists,
whether or not the company received fair value in the impugned transaction He said:

The Belmont case shows that the sale of an asset by the company at a fair value can properly be
described as giving financial assistance if the effect is to provide the purchaser of its shares with
the cash needed to pay for the loan. It does not matter that the company's balance sheet is
undisturbed in the sense that cash paid out is replaced by an asset of equivalent value. In the case
of a loan by a company, to a credit worthy purchaser of its shares, the balance sheet is equally
undisturbed but the loan plainly constitutes the giving of financial assistance. Financial assistance
is not determined by the impact of a transaction upon a company's resources. Rather, the
prohibition is contravened if the financial assistance was the only or the main purpose of the
transaction164 (Emphasis added).

161 Brady [1989] AC 755, HL.
162 Ibid at 403. Applied in Salgate Insurance Co Ltd v Knight (1982) 47 ALR 663; Rolled Steel Products v British
Steel Corp [1985] 3 All ER 52.
164 Ibid at 6.
His Honour Concluded:

There is no definition of giving financial assistance in the Acts, although some examples are given. The words have no technical meaning and their frame of reference is in my judgment the language of ordinary commerce. One must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance by the company, bearing in mind that the provision is a penal one and should not be strained to cover transactions which are not fairly within it.\(^{165}\)

If the reasoning illustrated in *Belmont Finance* and, as interpreted in *Charterhouse Investment Trust* is accepted as the correct interpretation of financial assistance, it is irrelevant, where the sole or main assisting purpose is present, that the company's resources are undiminished. A finding of contravention must be made even if the company's balance sheet is undisturbed or, a fortiori, if its assets are enhanced. One point made by Hoffman J is particularly attractive. Assume that the impugned transaction by the company is the making of a loan. Assume also that the loan is to 'a creditworthy purchaser of shares' who furnishes, entirely from his own resources, impeccable security which leaves no room for any possibility of loss. There is no question of diminution of the company's assets in accordance with the impoverishment theory and therefore no contravention of financial assistance law. But according to Hoffman J, the contravention is clear because, the given of a loan is prohibited by law.

The impoverishment theory may be contrary to the plain words of former s 206 (now s 260A). The purpose theory is justifiable in that, if a transaction is entered into in the ordinary course of commercial dealing, a company cannot be said to have given financial assistance even if the transaction did in fact financially assist. The word 'give' generally imports an intention to assist. In the ordinary course of a bona fide commercial dealing, the purpose of the parties thereto is not to assist each other. In *E. H. Dey Pty Ltd v Dey*,\(^{166}\) the court used the purposive approach to declare as prohibited assistance the giving by a company of a financial benefit to the vendor of the shares, causing such vendor to accept a reduced price from the buyer.

\(^{164}\) Ibid.
\(^{165}\) [1986] BCLC 1 at 10.
McInerney J ruled that the company assisted the buyer to obtain a reduction in the amount of money which they would be required to find in payment for their shares.

Generally, it is difficult to reconcile the ‘purpose theory’ with the ‘impoverishment theory’. The different effect between the two theories is illustrated where a company makes a loan to a credit worthy purchaser of its shares, who provides strong security and leaves no possibility of financial loss. The company’s assets will not be diminished in accordance with the impoverishment test but the purpose test is satisfied. Whether one adopts the purpose or impoverishment theory of what is meant by ‘financial assistance,’ the better approach is to look at the objective of s 260A and the rationale of the capital maintenance doctrine. If the legislative objective is to prohibit transactions detrimental to the interests of creditors and shareholders, one would favour the s 260A ‘materiality prejudice’ test which is consistent with the impoverishment theory. If the object is to prohibit absolutely those cases in which there is a real risk of detriment, one may be inclined to favour the ‘purpose test’.

The writer submits that the narrower approach, (i.e., the impoverishment and material prejudice tests) provide a better balanced approach.167 This is so, in the sense that the approach reflects the tenor of the Trevor rule and the capital maintenance doctrine168 by protecting the interests of creditors and shareholders. Section 260A encapsulates the policy entrenched by the capital maintenance doctrine which reflects the unauthorized reduction in the capital of a corporation and the protection of the interests of the corporations stakeholders. Support for this approach can also be gleaned from the equivalent s 152(1) (iv) of the English Companies Act 1985 which provides that:

167 Although Charterhouse Investment Trust Ltd v Tempest Diesels Ltd [1986]BCLC1 at 10-11 is placed under the ‘broader’ approach, it is consistent to a larger extent with the impoverishment test since it assumes that there could be no improper giving of financial assistance unless the company had made a net transfer of value, in connection with an acquisition by someone of its shares. This, of course is consistent with the decision of the Court of Appeal in Burton v Palmer[1980] 2 NSWLR 878. The preferred approach has recently received judicial approval in Law Society of NSW v Milos (2000) 18 ACLC 23 where Austin J approved of the argument that s 260A be interpreted in the light of its predecessors (reference here is related to the decision in Burton v Palmer. See also, Adler v ASIC; Williams v ASIC (2003) 46 ACSR 504 per Santow J.
168 Under the capital maintenance doctrine or the Trevor rule, the courts primary concern was the protection of creditors of the company from the ill effects of the diminution of the issued and outstanding capital of the corporation which would result from the purchase by the company of its own shares from existing shareholders.
any other financial assistance given by a company, the net assets of which are thereby reduced to a material extent, or which has no net assets ... contravenes s 151.\textsuperscript{169}

The purpose or broader approach is unfavourable because it has the disadvantage of being capable of harming the classes which s 260A aims to protect. Also, important to note is the fact that s 260A will not be contravened if it is established that, from a commercial perspective, the provision of the assistance was not materially prejudicial to any of the interests referred to in s 260A (1).\textsuperscript{170}

4.3.4.2. \textbf{Financial Assistance and Take-over Financing.}

The Greene Committee, which recommended the prohibition on financial assistance, was mainly concerned about the practice of a syndicate borrowing funds to acquire a controlling interest in a company and then using the company’s assets to discharge the loan.\textsuperscript{171} The aim was to ensure that those who acquired shares in a company did so from their own resources and at their own risk and not with the help of the company itself. Particular concern was expressed about companies which are taken over and which, under their new controllers, assist their controllers to discharge the takeover costs. The prohibition of the above transactions was assumed to help prevent creditors and minority shareholders from being prejudiced by financial transactions which may be entirely unrelated to the company’s normal business activities, and also to prevent directors of companies using the company’s funds to manipulate the market in the company’s shares for profit or control related reasons.

The Greene Committee thought as ‘abusive’ when, for example, a bidder was permitted to obtain ‘bridging finance’ to acquire the targets’ shares on the understanding that, when the acquisition is complete, the bidder would be able to apply portions of the target’s

\textsuperscript{169} A literal interpretation of s 152(1)(iv) of the Company’s Act 1985 (UK), may be analogous to a limited extent to the narrower view in the sense that, it seeks to prevent a company providing financial assistance that would deplete the company’s assets or resources. The effect is that even if the financial assistance does not fall within the specific types that the draftsmen were able to foresee, it will nevertheless be unlawful if the company has no assets or, the consequences of the assistance is to reduce its net assets to a material extent.

\textsuperscript{170} This view is consistent with Searman LJ in Wallestoner v Mair [1974] 3 All ER 217, CA 255 which is to effect that the ban on financial assistance must have been enacted to protect the company’s funds and interests of creditors as well as shareholders.

\textsuperscript{171} See, Re VGM Holdings Ltd [1942] Ch 235 at 239 per Lord Greene Mr.
assets towards repayment of its acquisition funding.\textsuperscript{172} Perhaps the main concerns for prohibiting such transactions were that it prejudiced all creditors and shareholders.\textsuperscript{173} This prohibition is recast by s 151(2) of the English legislation which provides that subject to the exceptions in s 153:

When a person has acquired shares in a company and any liability has been incurred (by him or any other person) for that purpose, it is not lawful for the company or any of its subsidiaries to give financial assistance, directly or indirectly, for the purpose of reducing or discharging that liability.

Section 152(3) of the 1985 Act (UK), further requires that reference to a company giving financial assistance to reduce or discharge a liability incurred for the purpose of acquiring shares includes giving assistance for the purpose of wholly or partly restoring the financial position of the person concerned to what it was before the acquisition. By implication, where a successful offeror uses the target’s assets to discharge its liability it falls foul of s 152. If this interpretation is correct, this results in an enormous extension of the normal meaning of ‘liability’ and seems to mean that before a company can give any financial assistance to any person (whether or not the acquirer), it must assess its overall financial position before and after the acquisition and if, afterwards, it has deteriorated, must refrain from any form of financial assistance which is not covered by the exemptions. The difficulty of doing this after a takeover is mind-boggling.\textsuperscript{174} Though s 260A does not provide a similar restriction, case law interpreting the former legislation assumes such transactions to be unlawful. The legal issue in question is whether there is any

\textsuperscript{172} Greene Committee Report, above n 4 para 173. On variations of this, see, Selangor United Rubber Estates v Craddock (No 3) [1968] 1 WLR 1555; Karak Rubber Co v Burden (No 2) [1972] 1 WLR 602. The Jenkins Committee took the view that, such transactions where the company finances the purchase of its own shares could lead to the company parting with its funds either on inadequate security or for an illusory consideration. Where the speculation fails, there will be little consolation for creditors and minority shareholders. (See, Jenkins Committee, above n 4). This type of transaction is known in the American jurisdiction as Leveraged Buy-Outs (LBO) (which is a transaction whereby a purchaser of a company uses the assets of that corporation to finance the acquisition). Alternatively, it may be referred to as a takeover of a public company (often, a Management Buy-Out (MBO) which is a transaction financed by a high level of borrowing’s so that the offeror is left in a highly geared position. (Refer to, B. Holstrom et al, “Corporate Governance and Merger Activity in the US: Making Sense of the 1980’s and 1990’s” (2001) 15 J Econ Pers 121, 144.

\textsuperscript{173} Jenkins Committee, above n 4 paras 171-173. (“such loans would make the company to part with its funds either on inadequate security or for an illusory consideration”).

policy problem of a successful offeror using the target's assets to discharge its costs. If the target company agrees to compensate an offeror and the bid succeeds, it is difficult to see how creditors or shareholders are adversely affected. However, if the bid fails, it is evident that the interests of creditors and minority shareholders may be affected. It is unclear how s 260A or any of the English equivalent financial assistance provisions could regulate such transactions especially in Australia, where proprietary companies dominate.

The financial assistance prohibition may be triggered where the offeror has few assets of its own but intends to pay for the bid by borrowings which will be serviced or secured by the money and assets of the target. What is unclear is whether such a situation can be objectionable in all cases. Thus, if company A having gained control of company C, caused the corporation to validly pay a dividend which A then used to repay B, such a payment of the dividend arguably cannot prejudice the rights of creditors and minority shareholders will directly benefit from it. In Brady v Brady, Lord Oliver said:

If one postulates the case of a successful bidder for control of a public company financing his bid from the company's own funds, the obvious mischief at which s 151 is aimed at is the immediate purpose which it is sought to achieve is that of completing the purpose and vesting control of the company in the bidder... There may be some desirable reasons why a target company would be prepared to finance a successful offeror's costs, one of which is that the company may have fallen on hard times so that a change of management is considered necessary to advert disaster. It may merely be thought, and no doubt would be thought by the purchaser and the directors whom he nominate once he has control, that the business of the company will be more profitable under his management than it was heretofore.

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175 Generally, a takeover bid is an offer to all or most shareholders to purchase shares of a target (offeree company), where the offeror if successful will obtain enough shares to control the target corporation. In Kini Property Holdings Ltd v Shortland Properties Ltd [2002] NZCA 51 at 52, Glazebrook J defined an 'offeree' to mean a 'person who makes a takeover offer, whether in concert or jointly with any other person or not ... and, an 'offeree' company as a company whose shares, or any of them, are proposed to be acquired under a take-over scheme'.

176 The Jenkins Committee, had acknowledged that if the speculation succeeds the company and therefore its creditors and minority shareholders may suffer no loss. (Jenkins Committee, above n 4 paras 172-173).

177 This view is consistent with the UK Board of Trade, Report of the Company Law Committee (The Jenkins Committee) (1962) Cmd 1749, para 175.


179 Ibid at 780. Section 151(2) makes it clear that the law does not prohibit a company from giving financial assistance if the company's principal purpose in giving the assistance is not to reduce or discharge any liability incurred by a person for the purpose of the acquisition of shares in the company or its holding company, or the reduction or discharge of any such liability is but an incidental part of some larger purpose of the company, and
In *Heald v O’Connor*, Heald agreed to sell to O’Connor all of the shares in a particular company. To enable payment of these shares, Heald agreed to lend a sum of money to O’Connor which would be secured by a charge over the company’s assets. The court held that by giving the security the company had given financial assistance to O’Connor as purchaser of the shares, since without the security Heald would not have been willing to make the loan. It is difficult in this situation to see any serious problem because neither creditors nor shareholders interests are affected by the transaction. There might only be a contravention in accordance with the broader interpretation of financial assistance which includes the provision of a loan or guarantee. But nothing prevents a successful offeror pursuing such transactions for the interests of all stakeholders and in the absence of material prejudice s 260A will not be breached.

It would also be an anomaly as in *Re Willington Publishing Co Ltd*, where after a successful bid, the offeror acquired the entire share capital of another corporation that possessed large undistributed profits. Such reserves were then used to declare a dividend which would be applied by the offeror to pay for the shares it had acquired. Quilliam J held that there was no financial assistance being given because the payment of a dividend was part of the normal functions of a company. Under s 153 (3) (a) of the English law there would be no contravention of the financial assistance provision. But under s 260A (2) (b) financial assistance has been given because dividend payments are not exempted from s 260A (1). It is not suggested that such a transaction should fall within the purview of s 260A (1). It is also possible to argue that where a person acquiring the company’s shares obtains bridging finance on the security of the acquirer’s own net assets and acquires the shares without dependence on the company’s net assets this should obviously be outside the ambit of any financial assistance prohibition.
In *Baiokta Pty Ltd v Jackson*, the company had been the subject of a successful takeover bid as a result of which its only shareholders were the bidder and the bidder’s nominees. The bidder had borrowed to fund the bid. It subsequently proposed to restructure the group’s finances, including the acquisition costs, and for that purpose to obtain guarantees from all group entities including the target in favour of new external financiers. At a meeting of the shareholders of the company, all of the shareholders entitled to vote (i.e., the bidder and the nominees) voted for a special resolution to approve the company giving the financial assistance by becoming a guaranteeing subsidiary. The validity of the special resolution was challenged by some preference shareholders who, under the company’s constitution, were entitled to receive notice of and attend meetings of shareholders but not to vote on the resolution. The court held that s 260B (1) (a) precluded the bidder, and its nominees from voting on a special resolution to approve financial assistance because they were persons ‘acquiring the shares’ to which the financial assistance related. The court also held that the resolution could not be saved under s 260B (1) (b) because that section would be irrelevant.

This decision raises doubts on the correctness of the s 260B (1) shareholder approval procedures and raises questions on when s 260A should be relevant under takeover financing. Presumably, the court may be right in precluding those shareholders and their associates who were acquiring the shares from voting in favour of the resolution. Yet, in this particular case where all the shareholders are by implication excluded from voting under s 260B (1) (a), can s 260B (1) (b) not be used to save the resolution? Although the legislation is silent, it is evident that the *Corporation Law Review Act 1998* which introduced s 260B repealed the definition of the term ‘resolution’ to which the court referred. Since there is no definition of resolution in s 9, it can be argued that s 260B (1) (b) should have been held to be applicable to the facts of the case.

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182 See, *Selangor United Rubber Estate Ltd v Cruddock (No 3) [1968] 1 WLR 1555 at 1617.
184 Ibid. The court has said that since the meeting had been convened to pass a special resolution under s 260B(1)(a), the resolution could not be saved by s 260B(1)(b) because according to the court, s 260B(1)(b) refers to a “resolution” defined by s 9 to mean “a resolution other than a special resolution” and consequently, s 260B(1)(b) could have no application where the resolution was notified and passed as a special resolution.
Arguably, it is generally not conducive to regulate take-over financing by the financial assistance legislation. To do so, would be preventing useful management buy-outs from being realized in the sense that both section 151(UK) and s 260A respectively, are so broad that they prohibit some leveraged buy-outs because the assets of the acquired company would be, in fact the security for the acquisition.\textsuperscript{186} However, such leveraged buy-out transactions may also have the tendency to deplete the target’s assets to a material extent prejudicing the interests of creditors and shareholders.

In \textit{MT Realisation Ltd v Digital Equipment Co Ltd}\textsuperscript{187} for example, a purchaser (MTI) acquired the shares of a company (M) for £1. Through an agreement a transaction was initiated whereby MTI’s costs were to be settled by M company. M later went into liquidation and its liquidator claimed that the transaction breached s 151(2) of the UK statute. Laddie J found for the defendant by asserting that, where the acquisition proceeded the share exchange, there would be nothing to prevent the target from paying all the expenses which the bidder incurred to facilitate the share exchange irrespective of the amount. The above assertion may be correct in the sense that for jurisdictions like the European Union Member States where the share capital rules still play a significant role, a transaction from that perspective may adversely affect the liquid assets of the target company thereby placing its creditors and shareholders at risk.

The problems with this type of transaction are the lack of guidance or mechanism with which the financial assistance legislation could be used to address the situation. The problem of takeover financing is rife because the scope of the financial assistance itself which includes the restrictions and exemptions are too broad, and it is difficult to use the financial assistance rules to regulate such takeover financing, because of the difficulties of ascertaining when and how transactions agreed to between the offeror and the target company would fall foul to s 260A.\textsuperscript{188} What is also unclear is whether ss 260A-D prevent the

\begin{footnotesize}
\begin{enumerate}
\item This viewpoint is consistent with those of the writers of Ford et al, above 106 at 1187.
\item See, G. M. Lumsden, above n 175 at 112.
\item [2002] EWHC 1628 (Ch).
\item The Takeover Panel has noted that in any bid with financing conditions as complex and fundamental, it appears that there will be material risk of uncertainty to the status of the bid and the interests of its members. (See,
\end{enumerate}
\end{footnotesize}
takeover of a company based upon the use of funds which will be retired with moneys liberated from the target? If so, will it be financial assistance where the transaction was consummated on arms’ length terms or entered into on ordinary commercial terms as per section 260C (5)? Obviously, the answer is no because s 260A does have that affect.\textsuperscript{189} There is comparatively nothing in either s 151 (UK) and s 260A which can adequately prevent the practice of a successful offeror using the target’s assets to discharge its costs. If the policy goal of the financial assistance principle was only to protect minority shareholders, there would be little concern with a successful offeror using the target’s assets to discharge its costs because in all cases, the corporation must be fully owned to enable such transactions to take place. Moreover, if minority shareholders would be prejudiced, it is suggested they can invoke the oppression remedy procedures found under s 232-234 of the Corporations Act rather than relying on s 260A for their protection.

The preferable method in preventing or regulating the practice of takeover financing is to adopt the Canadian approach. In Canada, for a company to provide financial assistance, it must satisfy a statutory dual solvency requirement.\textsuperscript{190} Also, section 44 of the \textit{Canadian Business Corporations Act 1990} allows a corporation that purchases all the shares of another company to then obtain financial assistance from that wholly-owned subsidiary including, financial assistance for any debt acquired to purchase the subsidiary. Accordingly, a successful acquirer can use the targets assets to pay its costs without breaching s 44.

\textsuperscript{189} Cf Re Myer Retail Investments Pty v Lid (1983) 8 ACLR 102 and Darwall v North Sydney Brick and Tile Co (No 2) [1980] 1 All ER 393 at 404 where the courts expressed the view that such transactions would breach former ss 129 and 205 of the old law. It is noteworthy that the perennial bugbear for acquirers under the old law was the restriction in the sections against a company giving financial assistance in connection with the acquisition and to prevent such unacceptable dealings on the believe that it disadvantaged creditors and shareholders. Even if correct, one does not see how previous shareholders of the target may be affected even where they sold at a low price because it was in their choice to sell.

\textsuperscript{190} This requirement which has previously be explained under the chapters of reduction of capital and share buyback, requires the company to meet the cash flow test of solvency and the balance sheet test of solvency.
The policy rationale for the CBCA is to facilitate the borrowing arrangements that are commonly made in today's business world. Section 199 adds that no cash takeover bid may be made unless the offeror is in a financial position to pay for what it proposes to purchase or in the absence of such cash, to make the adequate arrangements to implement the transaction. It is also important to note that in Canada, leveraged buy-outs are not directly regulated under the Canadian Business Corporations Act. In *Malcap Holdings Inc v Kelvin*, the court said:

> The fact that the offeror is for all practical purposes insolvent does not bar it from making a takeover bid provided it complies with the law and regulations. The purpose of the legislation regulating takeover bids is to safeguard the rights and interests of the shareholders of the offeree corporation, not those of the offeror... While no cash takeover bid can be made unless the offeror is in a cash position to pay for what it proposes to purchase or has made adequate arrangements, adequate bridge funding from a bank, followed by financial assistance in the form of loans or guarantee from the target corporation after the purchase is acceptable under section 199.

This part of the study has presented a direct and fundamental challenge to the notion of corporation law in the area of takeover and financial assistance. The weaknesses of the legal protection of creditors, minority shareholders and employees of the target company by financial assistance law are thus manifest. Although takeover financing may have its weaknesses, it is suggested that in a free market economy, the law ought to facilitate rather restrict takeover bids which result in the freeing of idle resources. So long as there are no unfair dealings, creditors are not harmed and minority shareholders not prejudiced, it is desirable that a successful bidder should be able to mobilize the assets of the acquired company and to deplore them as the bidder wishes. The above analysis leads to the conclusion that takeover financing cannot be effectively addressed under the financial assistance regime and that any significant recommendations for reform of financial assistance provisions must involve a far more reaching inquiry into takeover financing and the protection of the various stakeholders.

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193 Ibid. In *Re Calgary Power Ltd and Atco Ltd* (1980) 115 DLR 625 (Alta QB), the court seem to focus on whether the shares to be purchase by the bidder will be paid for and not on the arrangement following the takeover bid.
194 While there remain some concern in the financial and business community as to the validity of financial assistance
4.3.4.3. Regulation of Financial Assistance and Conflicts of Interests.

There is no one definitive approach to the regulation of financial assistance and conflicts of interest. Different jurisdictions use different regulatory mechanisms which are either doubtful or debatable. For example, in Canada, under s 44 of the Canadian Business Corporations Act, the asset and solvency tests are used for the regulation of financial assistance. Delaware and other American jurisdictions use a combination of the directors' duties provision, a dual insolvency requirement and other non-statutory means. The UK relies on enhanced disclosure obligations, fraudulent trading laws, directors' duties and the asset test. Australia uses a combination of directors’ duties and insolvent trading provisions, related party provisions and oppression remedy procedures. However, when s 260A is placed within the overall framework for the regulation of conflicts of interest and the hard question is asked-can all financial assistance transactions be satisfactorily regulated through these various mechanisms, it is possible to argue that there is some overlap and confusion of policy objectives.

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195 See, chapter 8 of this thesis for a detail evaluation of the insolvent trading provisions.
196 Sections 232-234 provides a statutory means whereby corporate stakeholders may gain redress for corporate conduct which has one of the effects described in s 233. The oppression remedy provision serves as a judicial brake against abuse of corporate powers, particularly, but not exclusively, by those in control of corporations and in a position to force the will of the majority on the minority. The provisions enable the court to interfere in the affairs and operation of a corporation and to effectively override the decisions of those charge with the responsibility of corporate governance. The oppression remedy provision reinforces the s 260A(1)(a) 'materially prejudice' procedure by ensuring that a financial assistance does not materially prejudice the interests of the company or the shareholders as a whole. Section 232 provides that the court may make an order under s 233 if; the conduct of the company's affairs or a resolution or a proposed resolution, of members or a class of members is either contrary to the interests of the members as a whole; or oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members whether in that capacity or in any other capacity. This remedy, assists in not only mitigating the conflicts of interests between directors, controlling shareholders and minority shareholders but also, ensures that shareholders are treated fairly and reasonable on any financial assistance transaction. (A detail analysis is provided in Chapter 8).
197 It is importantly noteworthy that chapter 8 of this study be consulted where a detail and rigorous analysis of the various statutory and regulation mechanisms of the capital maintenance doctrine are jettisoned. On weaknesses of the legal rules in regulating financial assistance, see, B. R. Cheffins, Company Law: Theory, Structure and Operation (Oxford: OUP, 1997) at 227-232
4.3 Comparative Amelioration (Regulation)

4.3.4.3.1. Director’s duties and the s 588G duty provisions.

In *Breen v Williams*, 198 Gaudron and McHugh JJ said:

In this country, fiduciary obligations arise because a person has come under an obligation to act in another’s interests. As a result, equity imposes on fiduciary proscriptive obligations not to obtain any unauthorized benefit from the relationship and not to be in a position of conflict. If these obligations are breached the fiduciary must account for any profits and made good any losses arising from his conduct of the business... 199

Case and statutory law requires that company’s resources are to be used only for corporate purposes. 200 The giving of financial assistance would, in general, be an improper use of corporate funds and a breach of the fiduciary duties of the directors. Section 260 is an attempt to frame more specific rules about an aspect of the principle of fiduciary administration that directors must use their powers for the benefit of the company and its corporators. 201 Directors remain subject to all normal duties in connection with a financial assistance transaction notwithstanding that the transaction might not contravene s 260A. 202 This is confirmed by s 260E which states that a director is not relieved from other duties under the corporation’s law or from fiduciary duties in connection with a transaction, merely because the transaction is authorized or approved by shareholders under the provisions of Ch 2J.4. Where directors give financial assistance in connection with an acquisition of interests in its shares, or the shares of its holding company, they could incur liability under the s 588G insolvent trading provisions. A company is taken to have incurred a debt under s 588G when it enters into an agreement to provide financial assistance, or if there is no agreement, when it provides financial assistance to a person. 204

198 (1996) 186 CLR 71,113
201 Section 260A(1)(a) for example requires a company to make financial assistance only if it would not materially prejudice the interest of the company or its shareholders or the company’s ability to pay its creditors.
202 Section 260E.
203 Sections 181-s 284.
204 Section 588G(1A).
In accordance with s 588G (1), directors could be liable if at the time the debt was incurred the company was insolvent, or became insolvent as a result of incurring the debt and there were reasonable grounds for suspecting that the company was insolvent or would become insolvent as a result of the debt being uncured. Directors contravene both s 260A (1) and s 588G unless the defences under s 588H are available to them. Arguably, because directors’ liability under s 260A (1) may only be triggered when s 588G is contravened it is unclear as to whether the directors’ fiduciary duties are relevant. Because there is a requirement for financial assistance to first be approved by shareholders which will assist in reducing the risk that such a power may be used by management to manipulate the market price or act otherwise, and because there is the s 588G insolvent trading provisions which imposes both civil and criminal liability on directors the need for a director fiduciary device may be a duplication of s 588G.

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205 Directors and other fiduciaries are exposed with the obligation to ensure that when a corporation approaches the vicinity of insolvency, their fiduciary duties extend to creditors in the sense that they must take positive steps not Ingersoll Publications Co, 621 A 2d 784 at 787 (Del Ch 1992), the Delaware Court of Chancery reasoned that directors’ fiduciary duties are created when ‘insolvency exists in fact or when a part institutes statutory proceedings’. Also, in Re Health Co International, 208 BR 288 (Bank. D Mass 1997), an American court held that directors of a solvent corporation run the risk of breaching their fiduciary duties to creditors when they vote in favour of a transaction that benefits shareholders to the detriment of creditors and other shareholders, if the transaction leaves the corporation insolvent or with an unreasonable small amount of capital. The issues advanced here are already being addressed by the s 588G duty and the s 260B (1) shareholder approval procedure. So why the need also for the directors fiduciary and statutory duties?

206 Section260B(1)

207 The criminal liability imposed on directors for contravention of s 260A (1) is to effect that a person commits an offence if they are involved in a company’s contravention of s 260A and the involvement is dishonest. The criminal penalty order for contravening s 260A(1) and s 588G results to the court making a pecuniary penalty order under s 1317G or an order under s 206C disqualifying a person from managing corporations, order the director to pay to the company compensation equal to the amount of the loss or damage (s 587J). The liability provisions reflect modern expectation and accommodates a modern concept of what being a director is all about, and also act as market response to community expectations. In ASIC v Donovan (1998) 28 ACSR 583, Cooper J opined that ss 588G and 1317 is punitive in character but also to act as a general deterrent to the general public against a repetition of like conduct. The legislative deterrent effect is aimed at preventing a corporate structure being used by an individual in the manner which is contrary to proper commercial standards to the detriment of the company, its shareholders, creditors and others dealing with it.

In almost all the chapters of this study, it has been suggested and canvassed that one of the optimum ways by which creditors could be protected from transactions affecting share capital is through regulation by the insolvent trading provisions. This is expressly supported by the Corporation’s Act.\(^\text{209}\) Therefore, it would be a more preferable approach to sever the director’s fiduciary duties from the insolvent trading duty and allow only the s 588G duty to be applicable to financial assistance transactions.\(^\text{210}\) This would serve the problems of duplication, and costs of litigation.\(^\text{211}\) However, as a stand alone mechanism s 588G would not be totally effective in regulating financial assistance.

\textbf{4.3.4.3.2. Related Party Provisions.}

The \textit{Corporations Act}, prohibits the giving of financial benefits, to related parties of public companies unless the benefits are covered by particular exceptions within the ambit of the arms terms clause or, under disclosure and shareholders approval provisions.\(^\text{212}\) The object of the related party provisions\(^\text{213}\) is to protect the company and its shareholders against certain kinds of transactions which could diminish the company’s resources and adversely affect shareholder’s interests. This legislation is connected to the s 260A financial assistance law in that it reinforces the materially prejudice test under s 260A(1)(a) by seeking to protect the interests of the company’s members by requiring

\(^{209}\) See, for example, s 256 relating to reduction of capital, (s 256B (1) (Note 3); s 256E (Item 1)); s 257 relating to buy-back (s 2573 (Item 1); s 254T relating to dividend payments (Note 1). All of these provisions had recourse to the insolvent trading provisions in regulating the various transactions.


\(^{211}\) Also, because directors may have wider means of being exonerated from liability under s 181-s183 than the defences available under s 588H, it would imply that where financial assistance transactions materially prejudice the interest of the company, its creditors and shareholders, these various interests would suffer a great loss without any remedy if for example, directors were exonerated under the s 180(2) business judgment rule. This acts as a buffer to personal liability by preventing the courts from reviewing the merits of business decisions made by directors (see, e.g., Wayde v New South Wales Rugby Ltd [1985] 61 ALR 225; Jones v Bradley [2003] NSWCA 81 at 113 per Sontow JA). Insurance indemnification of directors is another save haven which provides financial protection by the corporation for its directors (see, Companies and Securities Law Review Committee Report, \textit{Company Directors and Officers: Indemnification, Relief and Insurance} (1995). These remedies suggest that the s 588G provision provides stronger deterrent and punitive effect on directors and better protection to creditors than directors fiduciary duties. Furthermore, the s 181-183 provisions can have no application to s 260 because they are applied generally and not to any specific transaction.

\(^{212}\) \textit{Corporations Act} 2001(Cth), ss208-229.

\(^{213}\) Some discussion on related party transactions can be found in; P. Hanrahan, “Transactions with Related Parties by Public Companies and their ‘Child Entities’ under Pt 3.2A of the CL” (1994) 12 C&SLJ 138-143;
that, in general, financial benefits to related parties that could diminish or endanger those resources, or that could adversely affect those interests be disclosed and approved by a general meeting of shareholders.\textsuperscript{214} It further links with s 260 in the sense that the consequences for its breach embody both civil and criminal liability for breach of s 588G.\textsuperscript{215} The significant and perhaps questionable nature of the related party provisions and the financial assistance provisions can be gleaned under their exemption provisions. Both s 210 and ss 260C(2)(b) and 260C(5)(d)\textsuperscript{216} exempt a financial benefit and financial assistance from the shareholder approval and disclosure procedures provided the transaction was given at arm’s length, or on ordinary commercial terms. In \textit{Adler v ASIC},\textsuperscript{217} ASIC brought proceedings on behalf of HIHC, against Adler corporation, Williams and others for breach of certain provisions of the \textit{Corporations Act} which included ss 209 and 210 and s 260A(1) prohibiting financial benefits to related parties. The defendants argued that the said payments were not within the purview of the prohibition of any law because they were carried out on commercially arms-length terms consistent with the exemptions found under ss 210 and 260C.

A liability can probably be regarded as being incurred on ordinary commercial terms if it is genuinely incurred by a company in its own commercial interests, and not with a substantial purpose of assisting a person to make a relevant acquisition of shares or units.

\textsuperscript{214} See, ss 208-227 which states the requirement of member approval for the giving for the giving of financial benefit to a related party of a public company. Section 208 permits the giving of a benefit where the company has obtained the approval of its members in the way set out in ss 217-227 and has given the benefit within 15 months of approval, or the benefit false within one of the exceptions set out in ss 210-216.

\textsuperscript{215} Section 209 (2&3). Also, there is the continuing application of a director’s statutory and general law duties in connection with a transaction notwithstanding that it is a transaction authorised under the related party provisions. Moreover, the general transactions which are prohibited under s 260 and related party transactions include all loans to shareholders and directors (with exceptions provided as found under s 260C) or, exceptions to transaction undertaken under ordinary commercial arms-length terms. Section 229(3) provides the following as examples of ‘giving a financial benefit’ to a related party (giving or providing the related party finance or property; buying an asset from or selling an asset to the related party; leasing an asset from or to the related party; issuing securities or granting an option to the related party). Sections 210-216 lists the following exceptions to the requirement for member approval (Arm’s length terms; remuneration for officer or employee; indemnities, small amounts given to director or spouse; benefit to or by closely held-subsidiary; benefits to members that do not discriminate unfairly). Any financial assistance involved in a company discharging, on ordinary commercial terms, a liability that the company incurred as a result of a transaction entered into on ordinary commercial terms is not subject to s 260A. (Section 260C (5)(d)).

\textsuperscript{217} [2003]NSWCA 131.
Chapter 4  

4.3. Comparative Amelioration (Regulation)

of shares.\textsuperscript{218} If the transaction would not have occurred but for the company’s desire to financially assist an acquisition of its shares, the transaction might have been improper under predecessors of s 260A irrespective of the fairness of its terms.\textsuperscript{219} Under s 260A (1) (a), even if this exemption was unavailable, the transaction would only be improper if it materially prejudiced one of the interests referred to in that provision. Under a materially different predecessor of s 260A, if the company’s purpose in entering into the transaction was not to provide financial assistance, the liability could be regarded as being entered into on ordinary commercial terms even if the company was aware that its practical effect would be to provide financial assistance.\textsuperscript{220}

What is unclear with the regulation of financial assistance by the related party provisions is the absence of systemic criteria in determining when a transaction is within an arm’s length terms or ordinary commercial terms. It is less clear as to whether under s 260C (5)(d) the liability that is incurred as part of the overall transaction which involves the provision of the financial assistance, or whether the liability must have arisen under an earlier and independent transaction to be within the arms’ length terms. The latter approach was adopted by Parker J in Fitzsimmons v R\textsuperscript{221} in the context of the predecessor of s 260C (5) (d)-where it referred to the discharge ‘of a debt incurred’.\textsuperscript{222}

If the narrow view of s 260C (5) (d) is correct, it would not seem to be possible for a company to enter into an agreement if it knew that, in doing so, it would assist a person to acquire its shares. For example, how could a company agree to pay an executive a salary if it was aware that the executive would immediately use some of the salary to acquire the company’s shares?\textsuperscript{223} Arguably, s 260C (5) (d) does not expressly require that the transaction be discharged in accordance with the terms of the transaction. Rather, the

\begin{itemize}
\item \textsuperscript{218} Dempster v NCSC (1993) 10 ACSR 29 at 352-3 per Malcom CJ.
\item \textsuperscript{219} See, Belmont Finance Corp Ltd v Williams Furniture Ltd (No 2) (1980) 1 All ER 393 at 401 per Buckley LJ; Milburn v Privit Ltd (1997) 15 ACLC 1520 at 1547-9 per Goldberg J.
\item \textsuperscript{220} See, Belmont Finance. (Ibid.) A transaction would not be on ordinary commercial terms if, for example, a company agreed to purchase assets at a price which it knew to be inflated (see, Re VGM Holdings Ltd [1942] Ch 235 at 240 per Lord Greene MR diota.
\item \textsuperscript{221} (1977) 23 ACSR 355; 15 ACLC 666 at 682.
\item \textsuperscript{222} It has been argued that no debt or liability can be discharged unless it exists. (See, J. Hambrook, above n 104 at 26.383).
\item \textsuperscript{223} This is consistent with J. Hambrook’s reasoning. (Ibid.)
\end{itemize}
discharge must be on ordinary commercial terms. Section 260C (5) (d) does not expressly require that the transaction must be in accordance with the terms of the transaction. Rather, the discharge must be on ordinary commercial terms. What is ‘ordinary commercial terms’ or ‘arms length terms’ as required by both the financial assistance and related party provisions cannot be easily reconciled. Therefore, it is difficult to see how the related party provisions can be used in regulating financial assistance since parties in disputes face an uphill battle in satisfying a court that they are dealing at arm’s length, despite their relationship.224 Arm’s length transactions may be difficult to achieve between related parties. The arm’s length test appears to be too general so that transactions which should have been prohibited are permitted without infringing both the related party and financial assistance restrictions.225 Related party provisions could be an effective device in mitigating conflicts of interest generated by certain corporate transactions such as leverage or management buy-outs in the sense that interested director’s in most cases, distance themselves from the management of the company but, there is much uncertainty if such a regime is the appropriate vehicle for regulating financial assistance transaction.

4.4. Conclusion.

The Greene Committee, who recommended the law and prohibition on financial assistance, may have misdirected its solution to the problem that arose in the mid 1920’s. Reasonably, most companies are formed to undertake business activities which involve lending or pledging their resources to enable persons to acquire their shares, which are effective and efficient commercial transactions. Section 260A is an improvement from

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224 See, Trustee for the Estate of the Late AW Furse (No 5) Will Trust v Federal Cmr of Taxation (1990)21 ATR 1123 at 1132. In Elmslie v Federal Cmr of Taxation (1993)93 ATC 4, 964 at 4, 967, the Draft Income Tax Ruling (IT 93/D40) at para 234 States: “The fact that parties to an agreement are under common control will raise a prima facie presumption that the parties were not dealing on ordinary commercial terms with each other. However, ... other factors such as pricing and the terms or conditions of the agreement may be enough to overcome this presumption, if they show that the agreement was concluded on the basis of arm’s length dealing, that is, if rates available on the open market to the world at large and the normal terms of trade available to those parties in the relevant market were adopted”.

225 Certain transactions will inevitably be outside the exceptions. For example, intra-group loans and guarantees cannot be regarded as on arm’s length terms nor, will remuneration benefits to directors fall within the arm’s length terms. Given the broad range of terms that maybe struck at arm’s length depending on the skill and bargaining strength of the parties, a deal would have to look very strange to fail the ordinary commercial or arm’s length test. (see, generally, Ford et al, above n. 93 para 9.530; A. Greenwood, “A Significant Liberalisation of the Present law in favour of Directors’ Commercial Judgment” (1992) 21 BCLB 285).
previous legislation and does not require any serious change or amendment. This accords with the materially prejudice and financial impoverishment tests which recognise that giving financial assistance for the purchase of shares in the company, provided it is undertaken with due regard for the interest of the company, its members and creditors, and does not diminish the financial resources of the company, may serve the company’s interest. The current law also relies on an improved regulatory regime.

However, section 260A is still plagued with difficulties in certain material respects. Its improvement is blighted by the absence of a source from which the financial assistance is given. To this effect, to reinforce the s 588G insolvent trading provisions, it would be more appropriate that future law reform consider the Canadian and New Zealand approach where financial assistance is only allowed if the company would be able to meet a dual solvency tests at the time of entering into the contract and, at the end of the transaction. (That is, a cash flow and balance sheet solvency).226 If the solvency requirement is combined with the s 588G provision, it will provide a more effective regime and a model than those of Canada and New Zealand. Section 260 is further blighted by the s 260C exemption provision which assumes dividend payments constitute financial assistance.

Though the current law on dividends has its peculiar problems, examples from comparable jurisdictions where lawful dividend payments does not contravene financial assistance, can be a model for adoption in Australia.227 The s 260A (1) (a) materially prejudice test and the words ‘financial assistance’ warrant clarifying legislation. That definition can be simplified in the sense that the prohibition applies only in circumstances where the corporation’s assets have been diminished in a material extent, and where the interests of both creditors and shareholders are threatened. The interests of shareholders as a whole can be adequately protected through the combination of the special shareholder resolutions provisions and the oppression remedy provisions under s 232-234 of the Corporations Act.

226 See, for example, Canadian Business Corporations Act (CBCA) 1999, s 44.
5.1. **Introduction.**

Anglo-Australian laws adopt uniformly the traditional common law view of the capital maintenance doctrine, by restricting dividend distribution to shareholders except out of profits.\(^1\) The philosophy which has been consistently applied by the courts revolves around the principle that paid-up capital should not be returned to shareholders before a winding up, except under strict conditions. While creditors may legitimately assume the risk of business failure, thereby causing the loss of the capital of the company, they should be protected by the law against it being paid back to the shareholders.\(^2\) That policy rationale notwithstanding, the concept that dividends can only be paid out of profits has been made more complicated and problematic due to the absence of a clear definition of profits, and the lack of a consistent approach to determining when profits are available for distribution.

Profit has proven to be an elusive and baffling concept for the courts.\(^3\) The general Australian dividend law remains antiquated,\(^4\) applying definitions of distributable profit that no longer reflect commercial practice or accounting standards. The aims and objectives of this chapter are to demonstrate the difficulty of ascertaining profits; to demonstrate that the law on defining profits is inconsistent with modern accounting practice; to demonstrate that the current

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\(^1\) The term dividend is not defined in the Corporations Act. However, it usually implies a share of profits periodically payable: *Churchill International Inc v BTR Nylex Ltd* (1991) 4 AC 693. Also, depending on the context used, it has both a narrow and wider meaning: see, *Slingsby v Westminster Bank Ltd* [1931] 1 KB 173, 188. *Income Tax Assessment Act* (“ITAA”) 1936, s 6(1) provides that any distribution made by a company to any of its shareholders, whether in money or property, is a dividend. Dividends can only be paid out of the ‘profits’ of the company. See, *Companies Act 1985* (UK), s 263 and, *Corporations Act 2002* (Cth), s 254T.

\(^2\) This is reflected by the passage of Jessel MR in *Re Exchange Banking (Flitcroft’s case)* (1882) 21 Ch D 519, 533. This was adopted by the Australian High Court in *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567 per Mason J.

\(^3\) This view is consistent with Gower and Davies, *Gower and Davies Principles of Modern Company Law*, 7th (ed) (London: Sweet & Maxwell, 2003) at 275.

\(^4\) The method by which dividend and profits, for example, were determined in *Marra Developments Ltd v BW Refe Pty Ltd* [1977] 2 NSWLR 616 (“dividends can be paid from current years trading profit despite past losses”). This approach has not only been frowned upon by contemporary accounting standards, but may have a serious effect on creditors of the company.
law does not maintain capital because it allows dividends to be paid despite past trading and capital losses; to demonstrate when profits exist to fund a dividend; to demonstrate that the remedies available to recover unlawful dividends are unclear and to demonstrate that creditors' interests would be better served if dividends were payable as long as the corporation remained solvent. The chapter evaluates the judge-made and statutory laws on dividend distribution with the aim of exposing their weaknesses, and makes possible suggestions for future legislation. Section 5.2 traces the legislative history. Second 5.3 analyses the methods and mechanics of dividend distribution. Section 5.4 discusses some policy issues. The last sections suggest an alternative regime for the regulation of dividend distribution. The study concludes that the law on dividend distribution can adequately be regulated by the solvency tests and insolvent trading provisions. This would also make the law consistent with the proposed regulation of share buy-back and reduction of capital.

5.2. Legislative Development

As demonstrated in most sections of other chapters of this study relating to legislative history, the historical development of the rule on dividend distribution relates to the theme of the thesis in many material respects. Firstly, the legislative history illustrates how the rule on dividend distribution interacts and relates to chapter 1 on capital and chapter 3 of reduction of capital, but how it is inconsistent in approach. Secondly, it will show the development of the different sections of the law in Australia and the UK, and how Australian courts and legislation accepted and currently retained the traditional English model without much enquiry even after the English have abandoned most of the traditional determinants. Thirdly, the legislative development will demonstrate how the courts and legislature did not attempt to adequately regulate dividend distribution and define the term profits, though they made numerous attempts in subsequent years under the auspices of

international accounting standards. Moreover, the history shows that though Australia has shifted from a par value regime to a no par value regime, and from maintenance of capital to maintenance of a company’s assets as found in other transactions such as buy-back and reduction of capital, the distribution of dividends out of profits continues to have all the vestiges of the par value regime and the maintenance of capital. Finally, the development of the history of the legislation provides the benchmark for recommending a repeal of the current s 254T in favour of a universal solvency requirement for the protection of creditors and shareholders.

5.2.1 English History

The Joint Stock Companies Act 1840, was the earliest of the statutes to attempt to regulate dividends. Section 25 authorised registered companies to declare dividends out of profits of the concern. Reflecting the then state of accounting principles, the Gladstone Committee had reported that:

It was doubtful ... whether the payment of dividend out of capital was susceptible of sufficient accurate determination to be legislated upon.

As a response to the Gladstone Committee, the Limited Liability Act 1855 was enacted. It was the first to furnish the foundation upon which was erected the structure of the law governing the liability of company directors and shareholders for the declaration of dividends having profit as their source. The Act is however, merely a declaration of what the courts earlier said in Burnes v Pennel, that dividends should only be paid out of capital, and directors who paid a dividend when the company is known by them to be insolvent or, any dividend the payment of which would to their knowledge render it insolvent, they shall be jointly and severally liable to creditors of the company to the amount of such dividend. The Act fell short of declaring expressly whether a dividend

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6 (7 & 8 Vict 110).
7 First Report of the Select Committee on Joint Stock Companies, (Gladstone Committee Report) (1844) British Parliamentary Papers (1844) VII.
8 Ibid.
9 (18 & 19 Vict 133). Similarly, see, the Companies Consolidated Act of 1865 (8 & 9) s 1212 which provided that a company shall not make any dividend whereby their capital stock will be in any way reduced. This Act also made reference to dividends in its articles of association, under Table A, which stipulated that 'dividends must only be paid out of profits'. However, it applied only to public companies.
10 (1849) 2 Hl. Cas 489.
11 (18 & 19 Vict c 133), s 9.
presupposes profits. It was repealed by the Companies Act of 1856\textsuperscript{12} which was further repealed by the Companies Act of 1862.\textsuperscript{13} Table A however, reduced the language of the 1856 Act into a single statement, by removing the phrase: ‘arising out of the profits of the company’, to a single statement: “no dividends shall be declared except from profits”. However, since Table A is considered to be optional, it could not be said to provide a rule of law.\textsuperscript{14} The absence of an express regulatory provision on reduction of capital and dividend payments in the 1862 Act caused its repeal by the 1867 Act\textsuperscript{15} which was later consolidated by the Companies Act 1877.\textsuperscript{16} The 1867 Act provided a procedure by which stated capital might be reduced, with the sanction of the court. Where reduction of liability on partly paid shares or distribution of surplus was intended, the consent of creditors was required. While the Acts of 1867 & 1877 made provision to protect creditors, nevertheless, they supplied no standard for dividends.

There was no substantive statutory prohibition on a company paying dividends out of capital, and no general rules by the legislature regulating the distribution of a company’s dividends to its members. It fell originally to the courts to develop distribution rules out of the principles of the maintenance of capital. Thus, prior to 1889, a single unifying idea ran through the decisions in dividend cases.\textsuperscript{17} This idea, which was based on capital maintenance, was premised on the view that the provisions of the Acts regarding the capital of a company, and more especially its reduction, made it clear that the legislature would have frowned upon any dividend payment which would have left the company with a sum of assets less in value than its nominal paid-up capital. In Guiness v Land

\textsuperscript{12} (19 & 20 Vict c 47), Article 64 of Table A provided that: ‘no dividend shall be declared except from profits arising out of the business of the company’ (There was no mandatory provision or section expressly stating the rule).

\textsuperscript{13} (25 & 26 Vict c 89), Table A states: ‘no dividends shall be declared except from profits’.

\textsuperscript{14} It is important to note that, the fact that Table A is optional does not necessarily imply that a company not adopting it is free to pay dividends otherwise than out of profits. The 1862 Act may be interpreted as implying that while all companies may pay dividends only out of profits, those companies that adopt Table A are further restricted to profits arising from the business of the company.

\textsuperscript{15} (30 & 31 Vict c 131). In Driestitch Patent Salt Co v Curzon [1867] LR 3 Ex 35 for example, because the 1862 Act did not expressly regulate the reduction of capital, it was held that a reduction of capital was inconsistent with shareholders having limited liability. Also, see, Hansard (1866) 65 col 234; Hansard (1867) 75 col 277 where arguments for lifting the prohibition on a reduction of capital were advanced.

\textsuperscript{16} See, for example, Re County Marine Insurance Co (1870) 6 Ch App 104; Davison v Gillies (1880) 16 Ch D 347. These cases show the desire to see that the creditor’s security, the ‘capital’ of the company was not frittered away by its repayment to the shareholders either as dividend or in any other way.
Corporation of Ireland\textsuperscript{18}, an argument on the question of dividend payment came up for consideration. Directors had paid certain dividends but the Court of Appeal held that directors who improperly distributed corporate funds to members in the form of dividends were liable to refund the amount paid out since that was considered an unauthorized capital reduction. Counsel for the defendants argued that there was nothing in the Companies Acts forbidding the payment of dividends in whatever form the directors and shareholders saw fit. However, it was argued that the paid up capital of a company could be used only for the furtherance of the declared objects of the company which did not include the return to the shareholders of the capital they had subscribed.

The statutory ban on the reduction of capital, except under the strict supervision of the courts was held to imply that it was not legal to reduce the capital by returning it to shareholders without safeguards in the guise of dividends. This was reflected in 1882 in Flitcroft's case,\textsuperscript{19} where the Court of Appeal held that directors who had allowed debts, which they knew to be bad, to be credited in the accounts, thus creating fictitious profits, were liable to refund the dividends paid on their recommendation since these amounted to an unauthorized reduction of capital. It was here that Jessel M.R. explained the basis of the whole capital concept:

\begin{quote}
The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor therefore, I may say gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the company shall keep its capital and not return it to shareholders...\textsuperscript{20}
\end{quote}

A layman's view of profit was adopted by the courts to the effect that dividends could not be paid unless the books of the company recorded assets in excess of the amount of subscribed capital. Any excess over the subscribed capital which was the creditor's guarantee was profit which could be distributed to shareholders. Superficially, the rule was readily comprehensible.

\textsuperscript{18} (1882) 22 Ch D 349.
\textsuperscript{19} Re Exchange Banking Co (Flitcroft's case) (1882) 21 Ch D 519.
\textsuperscript{20} Ibid at 533-534. Cf. the "Trust Fund" doctrine enunciated by Story J in Wood v Dunmer (1824) 3 Mason 308. This is an example of American influence playing a part in the development of English Company law.
But the above cases, which stated that no dividend payments could be made unless the remaining assets, valued according to accepted conventions were at least equal to the nominal capital, were far from clear. In an attempt to redress loopholes in the early doctrine which was based on the value of the assets of the company and to pave the way for the development of a fresh approach, the courts from 1889, abdicated almost completely in favour of accountants and their business clients by laying down certain guiding principles and propositions. One of the propositions relates to the question as to whether dividends could be paid from fixed assets of a wasting company. In Lee v Neuchatel Asphalte\(^{21}\), the courts held that dividends could not be paid out of the money subscribed for shares or out of the assets acquired with the money. Lindley LJ sowed the seed of the new approach governing dividends. His Honour noted that the Companies Act contains no direct reference to the payment of dividends, and did not require capital to be made up if lost.\(^{22}\)

Also, in Bolton v National Land Co\(^{23}\), the court was of the opinion that capital losses of a company were immaterial in paying dividends so long as its current earnings were sufficient. Moreover, in Verner v General and Commercial Investment Trust,\(^{24}\) the courts formulated the concept of fixed and circulating capital with the reasoning that a company could pay a dividend even when its capital has been sunk. Lindley LJ put it thus:

> Fixed capital may be sunk and lost, yet the excess of current receipts over current payments may be divided though circulating capital must be kept up ...\(^{25}\)

He added:

> When it is said, and said truly, that dividends are not to be paid out of capital, the word ‘capital’ means the money subscribed pursuant to the memorandum of associated, or what is represented by that money.\(^{26}\)

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\(^{21}\) (1889) 41 Ch D 1.
\(^{22}\) Ibid at 19.
\(^{24}\) (1894) 2 Ch 239.
\(^{25}\) Ibid at 241.
\(^{26}\) Ibid at 265.
Gower et al\textsuperscript{27} summarized the judge-made rules as follows:

- Dividends cannot be paid if this would result in the company being unable to pay its debts as they fall due;
- So long as properly presented accounts of the company showed a trading profit for the accounting period (normally a year) it could be distributed by way of dividend without regard to losses made in previous years;
- A realized profit made on the sale of a fixed asset, as opposed to current assets turned over in the course of its trade, could also be distributed, so too could an unrealized profit on a revaluation of fixed assets (however, there were several conditions that had to be satisfied before this could be done).\textsuperscript{28}
- Accumulated profits of previous years could also be so distributed unless they had been capitalized by a bonus issue or transfer to the capital redemption reserve\textsuperscript{29}
- Losses, even revenue losses on circulating assets, made in previous accounting periods need not be made good. That each accounting period is treated in isolation, and once losses have been made and the capital fund thus reduced, creditors have no right to insist that future receipts shall be appropriated to its replacement.\textsuperscript{30}

The tracing of subscription moneys in particular assets, had certain consequences. First, if an asset was sold at a profit, that profit could be used for dividend purposes.\textsuperscript{31} Secondly, if an asset was lost, it was impossible to say that dividends could be paid out of the capital invested in those assets.\textsuperscript{32} The previous Company Acts which did not expressly regulate dividend distribution were consolidated by the \textit{Companies Consolidated Act of 1907},\textsuperscript{33} which was itself unhelpful because, it did not provide any guiding provisions for the regulation of dividend payments. To give effect to the principle formulated in the \textit{Verner} case, which distinguished between fixed and circulating capital, Schedule 8 of the 1948

\textsuperscript{27} Gower and Davies, (2003), above n 3 at 275.


\textsuperscript{29} The Jenkins Committee, strongly affirmed this proposition, subject only to a modest concession to aid reconstruction and amalgamation. (Refer, Jenkins Committee, above n 28 paras 342-350).

\textsuperscript{30} The Jenkins Committee (ibid), recommended unequivocally the abrogation of this proposition in relation to losses on revenue account

\textsuperscript{31} See, \textit{Re National Bank of Wales} [1899] 2 Ch 629 at 669 per Lindley MR.

\textsuperscript{32} In \textit{Ammonia Soda Co v Chamberlain} [1918] 1 Ch 266 at 296, Scrutton LJ said:

\textit{...When you have lost a thing you cannot lose it for anything else, because you have lost it. You cannot pay dividends out of a thing which you lost because it is not there to pay dividends out of.}

\textsuperscript{33} The 1907 Act stayed in force until the 1948 Act was enacted to further give effect to the legal status of dividend payment.
Companies Act was passed.\textsuperscript{34} The Act did not make provision for the regulation of the annual accounts which companies must lay before their members in a general meeting before dividends were paid. In 1960, the courts were divided on the issue as to whether a company could distribute its unrealised profits by way of dividends. In \textit{Westburn Sugar Refineries Ltd v Inland Revenue Commissioners},\textsuperscript{35} the Scottish Supreme Court held that unrealized profits are not distributable as dividends. However, in \textit{Dimbulala Valley (Ceylon) Tea Co Ltd v Laurie},\textsuperscript{36} Buckley LJ held that a dividend could be declared out of an unrealized accretion to capital.

Accordingly, to give effect to how profits and loss accounts were to be calculated and also to consider the suitability of the judicially formulated principles, the Jenkins Committee in 1962\textsuperscript{37} made nine important recommendations. These included:

- That provision for depreciation, replacement or diminution of value of wasting assets should be obligatory. Exception should be made for companies incorporated before publication of the Report or indication of their intention of adopting, a practice of making no such provision for wasting assets;\textsuperscript{38}
- A capital surplus arising on the revaluation of unrealized fixed assets should not be directly or indirectly available for distribution of dividend;
- The 1948 Act be amended to provide in respect of limited liability companies having share capital that a net realized capital profit may be treated as a distributable profit only if the directors are satisfied that the net aggregate value of the assets remaining after the distribution of that profit will not be less than the book value so that the share capital reserves and other reserves, remaining after the distribution will be fully represented by the remaining assets;\textsuperscript{39}
- Past revenue losses should be eliminated before profits of the subsequent years are distributable; thus the revenue account of a company should be regarded as a continuous account;\textsuperscript{40}

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\textsuperscript{34} (11& 12 Geo VI c 38), Sch I, Table A, Art 16 provides: ‘dividends may not be paid except out of profits’. Section 165 specifically declares that ‘every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account shall give a true and fair view of the profit and loss of the company for the financial year’. See also, s 56.

\textsuperscript{35} [1961] SLJ 297.

\textsuperscript{36} [1961] Ch 353. Cf. with the Australian case of \textit{Blackburn v Industrial Equity Ltd} (1925) 2 ACLR 8 at 16; (1977) 137 CLR 567 at 576 where Needham J at first instance followed Buckley LJ’s approach. See, the writer’s views in section 5.3.3. below at 239 where this issue is analysed in depth.


\textsuperscript{38} It is not clear if the Committee’s position would have been different if realized capital gains were to be distributed.

\textsuperscript{39} Ibid, paras 336-337.

\textsuperscript{40} Ibid, paras 336-337. If adopted, this would have reversed the decision in \textit{Ammonia Soda}. 
5.2. Legislative History (UK)

- Subject to any exceptions noted below, pre-acquisition profits attributable to any shares in another company should not be available for distribution as profits of the acquiring company;
- The date as from which the shares may be deemed to have been acquired for the purpose of the above, should in no case be earlier than the close of the latest accounting period of the acquired company before the contract was entered into;
- The prohibition mentioned above, should not apply to inter-group acquisitions;
- Where a holding company has acquired 90 per cent or more of the equity share capital of one or more companies in exchange for its own shares issued at a premium (or for no par value shares), it may treat as its own profits available for distribution to its shareholders, dividends received out of pre-acquisition distributable reserves of any one but (except with the consent of the court in the circumstances described below);
- To meet exceptional cases of hardship which may arise, the court should have power at any time to permit any company, of one or more other companies, to treat as its own profits available for distribution to its shareholders all or part of any dividend received by it out of pre-acquisition distributable reserves of the acquired companies. The procedure and the condition upon which the court should exercise its jurisdiction should be the same as on a reduction of capital under sections 66-69.

To reinforce the doctrine of maintenance of capital, the Second EU Directive\(^4\) supported the Jenkins Committee recommendations in 1977, which resulted in the enactment of sections 39-45 of the Companies Act 1980, making comprehensive statutory rules for the first time, for laws governing the calculation of profits for the purposes of dividend distributions. Section 39(1) retained the well-known formula but in a slightly different language: “a company shall not make a distribution except out of profits available for the purpose”. It however, altered its meaning by providing a new definition for the term profits. Section 39(2) defines profits available for distribution as:

Accumulated, realized profit, so far as not previously utilized by distribution or capitalization, less accumulated realized losses, so far as not previously written off in reduction or re-organization of capital duly made.\(^5\)

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\(^4\) 2\(^{nd}\) EC Company Law Directive (1976), art 15(1) regulates distribution to shareholders of public companies. The set of provisions in the 2\(^{nd}\) Directive impose a balance sheet test that does not allow distribution to shareholders “when on the closing date of the last financial year the net assets ... are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes”. The formulation of the 2\(^{nd}\) Directive leaves it for the courts to determine the scope of the Art 15 provisions.

\(^5\) Companies Act 1980, s 39(4) overrides the common law position by requiring provision for depreciation, renewals or diminution in value of assets to be taken into account before a company distributes dividends from profits. Section 40 prohibits a public company from making a distribution which would reduce its net assets below the aggregate of it’s paid up share capital and undistributable reserves. Section 44 (1) & (2) makes provision for the
Chapter 5  5.2 Legislative History (UK)

The 1980 Act adopted the Scottish court decision in Westburn Sugar Refineries and the Jenkins Committee approach instead of the Dimbula approach to the effect that, the Act directed attention away from individual accounting periods or gains on the sale of particular fixed assets and was committed to the capital maintenance doctrine as formulated by the courts, it recognized accounting practices and built on the accounting requirements of the Act.

While the 1980 Act made provision for a company’s distribution to be ascertained by reference to its annual accounts, it was the 1981 Act, which completed the process of the statutory regulation and valuation of dividends by prescribing the form and contents of company annual accounts and also, the rules by which items in the accounts were to be valued or calculated. Generally, while both the 1980 & 1981 Acts prescribed rules governing distribution, neither Act made any change in the law governing the way in which the distributable profits of a company might be applied, except by making them available for the redemption of shares. Also, like the judicially formulated rules, neither Act provided a comprehensive and acceptable meaning to the term ‘profit’.

The provisions above were consolidated to become what now are sections 263-281 of the 1985 Act. The rules of this Act, which are mandatory, enable both public and private

consequences of breaching s 39(1) by making the company to recover the amount loss from distribution from directors and shareholders who knew or had reasonable grounds for believing that a dividend was paid in contravention of statutory rules (although directors are liable to reimburse the dividends wrongly paid, they may seek indemnity from members who received dividends knowing that they were paid irregularly. See, Machan v Grant [1899] 1 QB 480). Section 45(4) requires that both capital and revenue profits and losses be taken into account in the computation of dividend distribution.

43 Westburn Sugar Refinery, above n 36.
44 Dimbula v Valley, above n 37.
45 Companies Act 1981, (S.I 1982 No 672) came into operation on the 15th of June 1982. Section 119(4) for example, amended s 45(2) of the 1980 Act, stipulating that distribution to members could be in the form of cash or any other form. Note that, under the 1980 Act, bonus shares for example, were excluded from distribution.
46 Both the 1980 and 1981 Acts recognized three different accounting methods for the calculation of dividends which included, the current earnings, the earned surplus and the balance sheet surplus methods. In accordance to the current earnings methods for example, profit is taken to be the actual receipts or gross earnings of the financial period, less expenses incurred in obtaining such receipts. No regard is paid to previous losses suffered. Profits carried forward could be distributed even though the company suffered losses in later periods.
47 Cf, Companies Act 1980, s 39(2); Re Spanish Prospecting Co Ltd [1911] 1 Ch 92.
48 Companies Act 1985, Pt VIII. This Act has been amended in various respects by the Companies Act 1989 especially in its attempt to provide a clearer meaning as to what are ‘realized profits’ and ‘realized losses’ (see, s 262(3)). Despite this, the 1989 Act has not provided a clearer understanding of the terms.
companies to impose additional requirements in their constitution. The current Act lays down for the protection of creditors, two basic principles relating to the payment of dividends and making of other distributions. One is s 263 applying to both public and private companies, and second, is s 264 applying only to public companies. Section 263 which provides the primary basis for the rule, provides that a distribution, whether in cash or otherwise, shall not be made otherwise than out of profits available for the purpose. The test for distribution is whether there are accumulated realized profits net of accumulated realized losses. This change results in two fundamental innovations from the judge-made rules. First, no longer may dividends be paid out of profits for the year, ignoring losses from previous years.

There must be a surplus of profits for the current and past years (so far as they are retained) over losses for those years (so far as they have not been lawfully written-off). Secondly, the profits must be realized. Although unrealized profits can be applied to pay up a bonus issue they can no longer be used to pay a dividend. However, the basic requirement that there must be accumulated realized profits net of accumulated realized losses has been certainly strained and difficult of application. There is the difficulty of determining whether at a particular date there are realized profits or losses. Moreover, the Act’s attempt to define those terms for the purposes of accounting provisions in Pt VII has raised a note of frustrated desperation.

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49 Ibid, s 281.
50 Excepted are distributions taking the form of bonus shares, redemptions, repurchases and reductions of capital carried out in accordance to statutory procedures.
51 Section 263(1), Section 263(3) re-enters the definition of profit as previously enacted. This is subject to the provision made by s 265 and s 266 for investment and other companies. This change results in two fundamental innovations from the judge-made rules.
52 Sections 270-276 contain accounting provisions which must be met before dividends can be distributed. They provide the rules governing the calculation of profits available for the distribution of dividends to shareholders. The sections are to effect that the amount for distribution should come from profits, losses, assets and liabilities, share capital and reserves, the balance sheet and profit and loss accounts, properly audited and which, must present a true and fair view. Some of the accounting provisions are complemented by the Stock Exchange Listing Rules. The objective of sections 263-281 are two-fold: (i) to ensure that creditors are not prejudice by the distribution to shareholders of funds that are properly to be regarded as part of the company’s capital buffer; (ii) to ensure that the fact that creditors are not prejudiced is suitably evidenced by the company’s accounting which is assumed provides a cushion for the protection of creditors.
53 The effect is that Westburn Sugar Refineries v IRC [1960] SL.T297 is adopted rather than Dimbula Valley (Ceylon) Tea Co v Laurie [1961] Ch 353. Also, unrealized profits cannot be used to pay up amounts unpaid on issued shares for this would conflict with the policy of ss 98 & 99.
54 For example, see, Gower et al, above n 3, 245.
55 Section 263(3) as inserted by the 1989 Act says:
Chapter 5

5.2. Legislative History (UK)

Under s 263 (2), distribution of assets to members in cash or otherwise is not permitted except on an issue of shares as fully or partly paid bonus shares; proceeds by a formal reduction of capital and a distribution of assets in winding up. The 1985 Act does not provide any criminal sanctions for unlawful distribution. In its stead, there is civil liability under s 277 to the effect that when a distribution is made to a member which he knows or has reasonable cause to believe is unlawful, the recipient is liable to repay the amount in whole or in part for which ever case the distribution was unlawfully made. The payment though unlawful, is neither void nor voidable. This liability provision is bound to cause certain difficulties. The fact that the section requires the recipient of the unlawful dividend to know, or to have reasonable grounds for believing that there is a breach of the law limits the impact of the statutory liability. The standard of expecting members apart from directors, to have constructive notice and to inquire whether a distribution was lawful or not renders both the common law and statutory liability questionable.

Generally, while the current law is an improvement, it is still marred by difficulties. Sections 263, 264 and 265 are somewhat misleading. They suggest that whether a distribution can lawfully be made depends upon the company having the requisite profits (and in the case of public companies, net assets) available at the time of payment and not

References in this part to realized profits and realized losses, in relation to a company's accounts, are with principles generally accepted as the time when the accounts are prepared, with respect to the determination for accounting purposes of realized profits or losses.

Gower et al, above n 3 at 277, remarked that the definition is sensible but that it does not solve any of the difficult policy issues which are entwined in this seemingly high technical issue. For example, is a profit realized only when there is a transaction with a third party which gives rise to the surplus? If the aim is to provide that profits count only when they can be identified with sufficient certainty and reliability, one could argue that a profit resulting from the appreciation of a listed security, traded on a liquid and deep market, should be recognized, whether or not that security is sold. The position for public companies differ in the sense that, those companies don't focus on the balance between realized profits and realized losses, but on the company's net asset position, once the dividend has been paid(see, s 264(2)).

56 In accordance to distribution in kind, s 276 provides that a distribution can only be made from realized profits. It is to effect that if a distribution is of, or includes, a non cash asset, ('non cash-asset') is defined by s 739 as 'any property or interest in property other than cash; and for this purpose cash includes foreign currency) it will nevertheless be treated as if it were a realized profit for the purposes of determining whether the distribution is lawful. This section was intended to facilitate de-mergers which had been rendered practical without adverse tax consequences by the Finance Act of 1981.

57 Refer to Precision Dippings Ltd v Precision Dippings Marketing Ltd [1986] Ch 447, CA. There, certain unlawful dividends had been paid and the shareholders were held liable. The shareholders pleaded innocence, arguing they had no knowledge that the dividends were unlawful. The court nevertheless held them liable on the reasoning that ignorance of a particular statutory provision had no effect on the breach of the provision. Cf also, Musham v Grant [1900] 1 QB 85, CA; Rolled Steel Products (Holdings) Ltd v British Steel Corporation [1986] Ch 246, 298.
5.2. Legislative History (Australia)

on the position some months earlier. What then is the position if, before the date of actual payment, the directors realized that the company is not going to meet those conditions at that time? Also, Articles 102 and 103 of Table A of the 1985 Act require the directors to make their recommendations in the notice of the meeting at which dividends are to be declared. Whether directors, should in the light of their then knowledge, not recommend a dividend will depend on the nature of that knowledge. If they have discovered that the relevant accounts were so seriously inaccurate that they did not in fact give a true and fair view of the state of the company’s affairs and its profits or losses at the time the accounts were signed, they clearly should not recommend a dividend otherwise; any dividend payment would be unlawful.\(^{58}\)

5.2.2. Australian Legislative History.

Prior to 1961, there were no precise statutory rules governing the regulation of dividends. Section 236 of the Company’s Act 1890 (Vic),\(^{59}\) adopted Table A of the English Companies Act 1862, only making reference to dividends and profits.\(^{60}\) The Australian courts have, on the whole, accepted that the decisions of the English courts correctly stated the law on dividends without much inquiry into their commercial soundness. In Australasian Oil Exploration Ltd v Lachberg,\(^{61}\) a company which had lost most of its capital, sold most of its valuable assets and distributed part of the proceeds to shareholders as dividends. Dixon CJ, McTiernan and Taylor JJ in a joint judgment stated:

> ... This argument asserted that if a company engages in a transaction whereby it disposes, otherwise than in the course of its trading or business activities, of a single asset for a price in excess of the value at which that asset stands in its books, it may lawfully distribute the usual profit so made among its shareholders whatever the capital position of the company might otherwise be. This proposition was rejected by Wolff J; and we agree with him in thinking that


\(^{59}\) (54 Vic, No 1074).

\(^{60}\) An older legislation was perhaps the Bank of New South Wales Act 1850, which incorporated the earlier unincorporated Bank Act, set up in 1817, provided in \$ 16 that no dividends was to be declared or paid out of subscribed capital or otherwise than out of the net gains or profit of the business. Table A of the English Act of 1862 was however adopted by the various State legislation making some reference to dividends and profits. For example, see, Companies Act 1896 (Vic) \$ 48; Companies Act 1915 (Vic), \$ 277(1) indicating that dividends include bonus and bonuses; Companies Act 1934 (SA), \$ 92, Table A, and Companies Act 1958 (Vic), \$ 277, all restating the language of the 1890 Act.

\(^{61}\) (1958) 101 CLR 119.
this is not the law. It is enough on this point to say that a company has no capital profits available for dividend purposes unless upon a balance of account, it appears there has been an accretion to the paid-up capital.62

The High Court accepted the above decision without expressly adopting the rule established in English cases concerning payment of a dividend from realized capital gains.63 To reinforce the common law position, the Uniform Companies Act 1961, section 376(1), was passed to put into statutory form the judge-made rules which required that “dividends can be payable only out of profits.” The section also required that profits cannot include unrealized increases in the market value of assets. This is reflected in Dimbula Valley (Ceylon) Tea Co Ltd v Laurie64 and Blackburn v Industrial Equity Ltd,65 where the Court of Appeal of New South Wales considered s 376(1) as authority for the proposition that unrealized profits cannot be transferred to the profit and loss account and used as the source of dividends. Section 376(1) further required directors in certain circumstances, to be liable to creditors for any unlawful dividend payments to an amount equal to profits improperly paid.

One important effect of the Act was to adopt the Jenkins Committee recommendations, that there be a common standard for the presentation of audit of accounts of companies.66 This required greater disclosure to be made in the shareholders’ meeting concerning the company’s balance sheet, and its profit and loss accounts.67

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62 Ibid, 133.
63 See, Lubbock v British Bank of South America [1892] 2 Ch 198; Will v London & Provincial Trust Ltd [1920] 1 Ch D 45.
64 [1961] Ch 353 at 372.
65 (1977) 2 NSWLR 616 at 628 per Glass JA, Contra Blackburn v Industrial Equity Ltd (1976) 2 ACLR 8 at 16 per Needham J.
66 Under the Jenkins Committee recommendations, the 1948 Act (UK) was amended to make for the provision of an annual account of a business, which will present information to the proprietors showing how their funds have been utilized and the profits derived from such use. (See, Jenkins Committee, above n 49 para 333).
67 Uniform Companies Act 1961, ss 161(1) & (2) required all company profits and loss accounts to reflect a ‘true and fair’ view of the company’s financial position. The degree of disclosure and the annual accounts of the company which is adopted by the 1961 Act have been criticized for not reflecting a proper accounting method because it is based on ‘historical costs’ accounting. It has also long been accepted in accounting practice that a balance sheet prepared for this purpose is an historical record and not a statement of current worth. For a clearer understanding of the 1961 Uniform Act, see, G. Sawyer, “Federal State Co-operation in Law Reform: Lessons of the Australian Uniform Companies Act” (1964) 4 Meb ULR 249; J. M. Young & J. M. Rodd, “Companies in Uniform” (1963) 36 ALJ 336.
Chapter 5

5.2. Legislative History (Australia)

Section 376(1) was considered problematical especially in regards to the construction of the word ‘payable’ as used in the Act. In *Marra Developments Ltd v BW Rofe Ltd*, the New South Wales Court of Appeal held that the critical time at which there should be profits was the date of declaration rather than the date of payment. Moffit P & Mahoney JA held that upon the true construction of s 376(1), the word ‘payable’, meant ‘payable’ and not ‘paid’. The court was of the opinion that if a final dividend had been validly declared out of profits but in the course of the company’s activities, no profits were available to meet the payment, it was no defence for the company not to meet the shareholders’ claim. Influenced by experience of the case law and the concern of overseas Company Law Review Committees, the 1980 Act consolidated the 1961 Act but still maintained the existing provision that ‘dividend shall be payable except out of profits. The Act did not require that revenue losses be charged against revenue profits, nor did it require that capital losses be recouped before a dividend could be paid. The 1980 Act did not adopt the Jenkins Committee proposals that previous revenue losses be made up from revenue profits before dividends can be declared.

The Act was amended by s 565(1) of the *Companies Act 1981*, which replaced the word ‘payable’ with ‘pay’. In the interpretation of the basic principle that dividends must only be paid out of profits, Mason J stated the rationale in *Industrial Equity Ltd v Blackburn*,

The principle which was certainly designed to protect creditors and I think, shareholders more particularly where there is more than one class of shareholders in a company, inhibits the payment by way of dividends out of a company’s capital. It is founded on the proposition recognized in

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68 The many problematic questions for the interpretation of s 376(1) included: Firstly, there was the question whether the profits of subsidiary companies could be recognized in the accounts of the holding company by revaluing the appropriate shareholdings. This was canvassed in *Blackburn v Industrial Equity Ltd* [1976] ACLR40-267 where Glass J who delivered the judgment accepted the *Dimbula* principle. The other critical issue was whether s 376(1) required that a company have profits of a sufficient amount to sustain the dividend recorded in the company’s accounts at the time of the declaration of the dividends or whether it is sufficient that profits be shown at the time of payment? In deciding in favour of the first interpretation, Mason J said however that, it is accepted that a company may declare a dividend which is to be paid or payable to shareholders at some future date. The Judge left out the important question whether the prohibition contained in s 376 applies only at the time when the dividend is declared or at the time when the dividend is to be paid.  
69 [1977] 2 NSWLR 616.  
70 Ibid, 616.  
71 Ibid, 616.  
72 Ibid, 616.  
73 *Companies Act 1981* (Cth), s 565(1) provides: ‘A company shall not pay a dividend to the shareholders of the company except out of profits... and profits cannot include unrealized increases in the market value of assets.

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Trevor v Whitworth that a reduction of capital can only be effected in accordance with strict statutory procedure and that there can be no return of capital except in accordance to that procedure.\(^73\)

Though the law on dividends was not significantly changed, it reasserted the validity of Gower’s first principle, to the effect that dividends should not be paid to shareholders if this would affect the solvency of the company.\(^74\) The 1981 Act was consolidated by s 201 of the Corporations Law\(^75\) which restated the repealed s 376(1) that no dividend shall be payable except out of profits or pursuant to s 191, the latter of which essentially required that no dividend be paid out of capital. This requirement was subject to certain qualification including court authorized share capital reduction under s 195; exceptions to financial assistance under s 205(8) (a) and permitted buy-backs under s 206AA.\(^76\)

In 1998, to address some defects in the previous Acts and to give effect to the Mawra Development decision, s 201 was amended and replaced by what is now ss 254T-254W\(^77\) of the Corporations Act. Section 254T abandoned the word “payable” as used in the

\(^73\) Ibid at 29.639.

\(^74\) The changed proposed by Gower was not expressly incorporated in the 1981 Act but was only contained in the 1981 Bill.

\(^75\) Corporations Law, ss 297-299 imposed some overriding requirements on corporate directors to present the accounts of the company in a ‘fair and true’ manner. For a discussion of the true and fair view concept, see, R, Chambers, P, Wolhizer, ‘A True and Fair View of Financial Position’ (1990) 8 CASLJ 353. The Corporations Law further restated the existing common law rules by providing that; (i) dividends may not be declared if this would result in the company being unable to pay its debts as they fall due (s 588F-G); (ii) dividends may be declared from increases in circulating capital without providing for losses of fixed capital (see, Lee’s case). In addition, it is not legally essential to make any provision for depreciation: Re Kingston Cotton Mills Co (No 1) (1986) 1 Ch 331; (iii) dividends may be declared from current years profit despite losses of circulating capital in previous years: Mawra Development, above n 25; Ammonia Soda, above n 18; (iv) dividends may be declared from profit arising from the sale of fixed assets (see, Australian Oil Exploration Ltd v Lichberg (1958) 101 CLR 119, 133 where it is noted that the company’s capital must however remain intact and only the increase in value may be used for the payment of the dividend; (v) dividends may be declared from unrealized increases in fixed capital, and dividends cannot be declared by a holding company from the profits of its subsidiaries.

\(^76\) Corporations Law, s 201(2) imposes a civil and criminal liability on the directors who contravened subsection (1) by declaring that any director or officer who knowingly pays a dividend, or permits a dividend to be paid, out of what are not profits nor in accordance with s 191, contravenes s 201. The officer in breach is liable to the company’s creditors for the company’s debts in so far as the dividend exceeded its profits. Section 201(5) requires a recovery of the amount of the dividend wrongfully paid by the company to its shareholders with the requisite standard of proof. Accordingly, any wrongful payments other than out of the profits of the company envisages a criminal liability of a prison term not exceeding two years and/or a fine of $10,000 by virtue of s 131(3).

\(^77\) These provisions are in effect that a dividend can only be paid out of the distributable profits of the company. Under s 254U (1), directors are authorised to determine that a dividend is to be paid, without declaring a dividend. This section which is now a replaceable rule leaves it for directors to pay and fix the amount, time for payment and method of payment (including payment by cash, the issue of shares, the grant of options or the transfer of assets).
Chapter 5  5.2. Legislative History (Australia)

former Act by stating that dividends may only be “paid” out of profits.\textsuperscript{78} The change of words was intended to alter the effects of the Marra Development case. However, the Corporations Act is silent as to what is profit. According to the Explanatory Memorandum to the Corporations Law Review Bill 1997, s 254T has the effect that profits must exist at the time fixed for payment of the dividend and not at the time of declaration of the dividends.\textsuperscript{79} Though s 254T prohibits the payment of dividends only from profits of the company, the law does not require a separate fund for dividend payments nor how profits are to be calculated; rather it states that a company’s profit and loss account must disclose profits out of which dividends can be paid.

The Corporations Act and case law require that money borrowed by the company may be used to pay dividends to the extent that the company’s account has distributable profits.\textsuperscript{80} Arguably, it is unclear if there is really a distinction between ‘moneys borrowed’ by the company and ‘loans’ given to the company. This anomaly needs to be adequately addressed. If not, borrowed moneys may be dressed up as loan funds and used as a safety margin.\textsuperscript{81} The methods by which a company may pay a dividend include the payment of cash, the issue of shares and the grant of options and the transfer of assets.\textsuperscript{82}

\textsuperscript{78} The statutory rule of paying dividends only out of profits of the company applies to all companies. This is consistent with the common law principles before the enactment of the first statutory enactment: Mackie v Clough (1891) 17 VLR 493 at 495 per Webb J.

\textsuperscript{79} Explanatory Memorandum to the Company Law Review Bill (1997) para 11.33. See, also, Mackie v Clough (1891)17 VLR 493, 495. It is also assumed that dividends are only paid whilst the company is a going concern (refer to, Re Crichton’s Oil Co [1902] 2 Ch 86, CA. Though the law permits a process which does not involve declaration of the final dividend, a final dividend may be declared if the company’s constitution makes provision for the declaration of dividends which, by implication, would mean the company incurs a debt when the dividend is declared (see, s 254V(2). (See a detail analysis of the question relating to the time when dividend exists below section 5.3).

\textsuperscript{80} See, Re Mercantile Trading Co (Stringer’s case) (1869) 4 Ch App 495; QBE Insurance Groups Ltd v ASC (1992) 32 FCR 290; 8 ACSR 649.

\textsuperscript{81} Should this be a ‘problem’ then is addressed in the sense that if the accounts reveal distributable profits, but the company does not have enough available cash to pay the profit by way of dividend, the company may borrow the necessary cash. This to an extent makes s 254T to be consistent with case law. (See, Mills v Northern Rly of Buenos Ayres Co (1870) I R 5 Ch App 621. But the money so borrowed with the funds of the company in hand must be sufficient to cover the dividend and all other liabilities then presently due and payable.

\textsuperscript{82} Corporations Act 2001, s 254U (1). In most cases, for a company to pay a dividend either in cash or other consideration, it must be sanctioned by its constitution and by its Replacesable Rule. (See, s 254U; Industrial Equity v Blackburn (1977) 3 ACLR 89).
The current law adopts the previous liability provisions for breach of s 254T. It is also a replaceable rule that the directors of a company may determine that a dividend is payable and fix the amount, the time for payment and the method of payment. Both the common law and the Corporations Act impose civil liability on directors who authorize payment of unauthorized dividends. Under both laws, directors who authorized such payments out of capital are personally liable to repay the amount of the dividend to the company. Where a dividend is paid in breach of s 254T without compliance with procedural requirements for authorized reduction of capital, the company contravenes s 256D. While the company is not guilty of an offence, any person involved in the breach is liable under the civil penalty provision. A director, who authorizes an improper dividend, also breaches the director's duty of care and diligence.

The current law is undoubtedly an improvement on the law of dividend distribution; however, it is not a model of clear legislation and creditor protection and lacks clarity. No small wonder, it has been a subject for discussion by the Australian Accounting Research Foundation, and the Corporations Committee of the Law Council of Australia. Both the Legislative Review Board and the Corporations Committee have proposed that s 254T be reformed in favour of a solvency test which is also in view of the proposed adoption of International Accounting Standards.

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83 Section 254U (1).
84 See, Re Oxford Benefit Building Society (1886) 35 Ch D 502. Under common law, one or more directors could be liable under the position of trustees for the whole amount. Those who have been fraudulent could be under liability to indemnify honest directors.
85 Section 180. Where the conduct is dishonest or fraudulent, the director is subject to a criminal liability under s 588G.
87 Corporations Committee of the Law Council of Australia (Corporations Committee) (September 2004) at <http://www.lawcouncil.asn.au>
5.3. Common Law and Statutory Principles Determining Dividends and Profits

The above common law propositions which have been statutorily re-formulated since the Jenkins Committee recommendations\(^{88}\) are now applied by both s 254T and s 263 (UK). However, while some are commercially sound others, remain questionable. The results of the above judicial and legislative principles on the law of dividends are too mixed, startling and conflicting, so much so that it has been difficult to establish a satisfactory criterion on how dividends are to be reckoned out of profits.\(^{89}\)

5.3.1. Lost of fixed assets need not be made good before paying a dividend.

In *Lee v Neuchatel Asphaltite Co.*\(^{90}\) a company was formed for the purpose of working a lease of asphaltite mines. After several years marked by generally profitable activity the company resolved to declare a dividend out of current year profits. A shareholder sought to restrain the company from paying the dividend, on the ground that the value of the company’s concession had depreciated and a large part of the capital had been lost. He argued that there were no profits until this depreciation and loss had been made good. The court said that a company exploiting a fixed asset does not have to provide for the replacement of capital lost through the decline in value of the assets before a dividend may be paid. Lindley LJ used the following example:

> [S]uppose a company is formed to start a daily newspaper, supposing it sinks £250,000 before the receipts from sales and advertisements equal the current expenses, and supposing it then goes on, is it to be said that the company must come to a stop, or that it cannot divide profits until it has replaced its £250,000, which has been sunk in building up a property which if put up for sale would perhaps not yield £10,000?\(^{91}\)

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88 Jenkins Committee, above n 38.

89 For purposes of this study, the general principles will be summed up into four propositions. (1) Should fixed and circulating capital be considered in the determination of dividends out of profits? (2) Should future receipts be appropriated for replacement or, should provision for depreciation and depletion be necessary before dividends can be declared and paid? (3) May unrealized increases in the value of a company’s assets be included in the calculation of dividends out of profits? (4) Should a company pay dividends in the current trading period without making good past losses?

90 (1889) 41 Ch D 1. The courts generally decided that before directors could recommend dividends, they have to set aside a reserve fund for contingencies, but they shall not be bound to form a fund, or otherwise reserve moneys, for the renewal or replacing of any lease. Ct: *Bolton v National Land Co* [1892] 2 Ch 124, where the court was of the opinion that capital loss was immaterial in paying dividends since current earnings were sufficient. Contra *Dent v London Tramways Co* (1880) 16 Ch D 1, 17; where the courts said that in determining what was profits meant for distribution, profits meant ‘net profits’ which are obtained after allowance has been made for depreciation in the current year.

91 Ibid at 22.
Lord Davey introduced the novel distinction between fixed capital or the amount sunk in the purchase of the undertaking and circulating capital, which stands upon a different footing. The fixed capital is sunk once for all and need not be maintained at the original value, but the circulating capital is parted with and must be replaced. Sterling J and Cotton LJ found that the proposed dividend was not improper and accordingly, the value of the company’s concession was not less than it had been at the beginning of its operation. They refused to require the company to preserve intact assets equal to the nominal value of the shares as required by Re Wragg Ltd.\textsuperscript{92} Lindley LJ said:

If a company is formed to acquire and work a property of a wasting nature, for example, a mine, a quarry, or a patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, it appears to me that there is nothing whatever in the Act to prevent any excess of money obtained by working the property over the cost of working it, from being divided amongst the shareholders, and this in my opinion is true, although some portion of the property itself is sold, and in some sense, the capital is thereby diminished. If it is said that such a course involves payment of dividend out of capital, the answer is that the Act nowhere forbids such a payment as is here supposed.\textsuperscript{93}

Lindley LJ further added:

There is nothing in the Acts about how dividends are to be paid, nor how profits are to be reckoned; all that is left, and very judiciously and properly left, to the commercial world. It is not a subject for an Act of Parliament to say how accounts are to be kept; what is to be put into a capital account, what into an income account, is left to men of business...The companies Acts do not require the capital to be made up if lost ... I cannot find anything in them which precludes payment of dividends so long as the assets are of less value than the nominal capital ... It appears to me that the proposition that it is ultra vires to pay dividends out of capital is very apt to mislead, and must not be understood in such a way as to prohibit honest trading. The directors may before commending any dividend on any of the shares, set aside out of the net profits of the company such sum as they think proper as a reserve fund to meet contingencies, or for equalizing dividends, or for repairing or maintaining the works connected with the business of the company or any part thereof, and the directors may invest the sum so set apart as a reserve fund, or any part thereof, upon such securities as they may select, but they shall not be bound to form a fund or otherwise

\textsuperscript{92} [1897] 1 Ch 796.
\textsuperscript{93} (1889) 41 Ch D 1 at 24.
reserves moneys for the renewal or replacing of any lease, or of the company's interest in any property or concession.  

It could be argued that the decision establishes the principle that since the law provides no remedy against watering of stock, as a logical consequence it will not require assets equal to the nominal value of shares to be preserved intact. Accordingly, the principle is to effect that losses of fixed assets need not be made good before treating a revenue profit as available for dividend, and it is not legally essential to make any provision for depreciation.  

The court did not formulate any new theory of dividend law but by the approval of the practice of ignoring declines in the value of the company's assets, the court significantly undermined the existing theory of the maintenance of capital.

Further, the above principle was not appealing to accountants, despite the opinion of commentators that the decision was in accordance with the principles of business. To reinforce the Lee decision, in Verner v General & Commercial Investment Trust, a similar issue was raised. There, a company was formed to invest in stocks, shares and securities of various descriptions and the income from such investments was by the constitution available for distribution as a dividend. The market price of some securities had fallen and others had proved worthless so that the value overall of the company's assets had materially diminished. However, the investment income for the year considerably exceeded expenses. The question in issue was whether the directors could divide the excess of receipts over expenditures and ignore the loss which had been suffered. One of the trustees of the company sought to restrain the payment of a dividend out of profits until the lost capital was

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94 Ibid, 19-24. What Lindley LJ was insinuating was simple that in the declaration and payment of dividends, there is no need to set aside any funds for the replacement of wear and tear. (I.e., the Companies Act do not require the capital to be made up if lost. If men of business think their prospects of success are considerable, as long as they pay their creditors, there is no reason why they should not go on and divide profits).

95 If an allowance is made for depreciation and the directors are satisfied that the actual value of the assets of the depreciated value shown in the books, they may write back the appropriate part of the depreciation and thus increase the profits available for dividend (see, Ammonia Soda Co v Chamberlain [1918] 1 Ch 266CA).

96 See, generally, (1889) 5 Law QR 221; [1889] LJ 353; [1889] Accountant 89. In one other journal, it was lamented that: "in his effort to free businessmen from the 'straight-jacket of a legal formula', Lindley LJ had sanctioned practices frowned upon by specialists in company accounting" (see, (1889) 5 LQR 221).

97 (1894) 2 Ch 239. There, the defendant company wished to pay a dividend ignoring the fact that some of its holdings had depreciated in value. The courts, relying on the Lee case, held that a past loss need not be made good before declaring dividends. In arriving at its decision, the courts relied on the concepts of fixed and circulating capital as determinants for dividend payment.

98 Alternatively, the question being whether anything prevents a company not in debt or well able to pay its debts, from paying dividends where capital sunk in creating the business was not represented by assets. Lindley LJ,
made up. Lindley and Smith LJJ in a concurring judgment, and following Lee’s case had this to say:

It is obvious that dividends cannot be paid out of capital which is lost; they can only be paid out of money which exists and can be divided...But although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company’s assets, it does not follow that dividends may be lawfully paid out of other assets regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape, and to divide as dividend the receipts, say, for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of business men. But the word ‘profits’ is by no means free from ambiguity....Perhaps the shortest way of putting clarity in our explanation is that fixed capital may be sunk and lost, and yet that excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up...It follows therefore that the proposed payment of dividend in this case cannot be restrained and it is plain, there is nothing which requires lost capital to be made good before dividends can be declared and paid...  

The rule here envisaged the division of assets into two classes: Fixed assets, which are permanently retained by the company and not intended for resale; and floating or circulating assets, which the company did not intend retaining for any length of time, but which have a short life-cycle of acquisition and displacement. Declines in the value of the former, as well as expenditure on their acquisition, need not be deducted from current receipts when calculating the dividends. But any devaluation of the latter, or any expenditure made on their purchase have to be treated as diminished items. As concerns creditor protection, this approach is questionable and can create anomalous results and even threaten their interests. This is reflected by the comment that the decision in the Verner case was indeed “fearful and wonderful.

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99 [1894] 2 Ch 239, 265-266. Sylvestre J, purporting to follow Cotton LJ in the Lee case, held that the loss was of permanent assets, so that it could be ignored in arriving at profits. It is important to note that the Lee and Verner decisions, influenced Australian decisions. See, for example, Phillips v Melbourne & Castlemaine Soap and Taylor and Owen JJ said: “Profits may, of course, be distributed by a company while a going concern even though a loss of paid-up capital previously incurred has not been made good”. See also, Australasian Oil Exploration Ltd v Lackberg (1958)101 CLR 119, 133.


5.3.2. Should provision be made for Depreciation and Depletion?

The effect of the common law cases previously outlined was that a company was not required to make any provision for depreciation on wasting assets.\(^{102}\) Accordingly, a company could declare and pay dividends out of profits of the particular year despite past losses\(^{103}\) in *Re National Bank of Wales, Ltd.*\(^{104}\) despite Wright J’s view that such losses had to be made good, Lindley LJ reversed the decision, by holding that the results of any period’s trading must be considered in isolation without reference to the company’s previous fortunes. The *National Bank* and the *Lee* cases were applied in *Dovey v Cory*,\(^{105}\) where the House tended to follow the Lindley series of judgments. Similarly, in *Ammonia Soda Co v Chamberlain*,\(^{106}\) the courts were of the opinion that dividends were payable from the excess of current receipts over current expenditure even though no allowance was made for depreciation or loss of fixed assets.\(^{107}\) Peterson J, focusing on the existing question as to whether trading losses must be made good before paying dividends, said:

> Where a company has made losses in past years and then makes a profit out of which it pays a dividend... such a dividend is not paid out of capital. If it were, the paid up capital would be still further reduced by the

\(^{102}\) In the *Lee* Case for example, the corporation owned a mine as its major asset. Lord Lindley pointed out that this was a capital asset which by nature diminishes in value as part of the company’s business. If the corporation generates a revenue profit from working a wasting asset such as a mine, then the profit may be used to fund a dividend without having to set aside money to compensate for the diminution in the value of the asset. This case is the source of the much criticized principle that depreciation need not be made good before dividends can be paid. In English law, the case was the first in which it was argued that a company in calculating divisible profits was not required by law to make any deductions from receipts for losses or depreciation of fixed assets. *Contra Dent v London Tramways* (1880) 16 Ch D 344; *Davison v Gilles* (1879) 16 Ch D 347, where Jessel MR indicated that a tramway company should make provision for the annual wear and tear on its track even if no repairs were actually effected to them in a particular year.

\(^{103}\) It is noteworthy that this issue initially came up in *Dent v London Tramway Co* (1880) 16 Ch D 344. "May a company declare dividends out of profits of a particular year despite past losses? Jessel MR dismissed the argument with effect that a company may distribute its current trading profits despite past losses. This position of Jessel MR is curious if note is taken to the fact that the 1867 &1877 Acts were passed as a result of his own decision in *Re Ebbw Vale Steel, Iron & Coal Co* (1877) 4 Ch D 827, and he is alleged to have said in that connection that no dividends was payable by a company with impaired capital unless a statutory reduction of capital takes place.

\(^{104}\) (1899) 2 Ch 629.

\(^{105}\) [1901]AC 477.

\(^{106}\) (1918)1 Ch 266.

\(^{107}\) Cases decided before *Ammonia Soda*, suggest that if courts had approached the problem of dividend from the standpoint of the rule that dividends may be paid only from profits, it is probable that they would have held that there cannot be said to be any profits until allowance is made for depreciation or loss of fixed assets. (Sec. generality, *Badham v Williams* (1902) 86 LT 191; *Thomas v Crabtree* (1912)106 LT 49; *Re Spanish Prospecting* [1911] 1 Ch 92). In *Davison v Gilles* (1879) 16 Ch D 347, Jessel MR indicated that a tramway company should make provision for the annual wear and tear on its track even if no repairs were actually effected to them in a particular year.
5.3. Principles Determining Dividends

For purposes of the capital maintenance doctrine and creditor protection, it is difficult to accept the views of the judges in both the Lee & Verner decisions. This view is consistent with that of one commentator, who is of opinion that the above judgments knocked the bottom out of the creditors' safeguard, in the sense that the decisions created an anomalous position to the effect that, an investment company which was in a poor way as a result of serious security value depreciation could jeopardize creditors' position by paying a dividend. The decisions also received a storm of disapproval from accountants who labeled the principles formulated by the judges as not only startling, but the most mischievous judgments ever given in relation to company matters.

A close reading of their Honours' opinions suggests they were merely attempting to distinguish losses arising on the return to shareholders of fixed assets or their proceeds of sale from all other forms of loss or depreciation of fixed assets. On many occasions, the judges misconceived 'depreciation' from 'appreciation' (i.e., an increase in market value). In Lee for example, the judges took the view that depreciation was the opposite of

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108 Ibid. Contra Sir Woodburn Kirby (one prominent accountant present in the House of Lords) who gave evidence that it was contrary to all principles of commercial accounting to write up the value of a fixed asset and apply the surplus so obtained to meet a deficit on trading. American commentators do not seem to favour the English precedents which they argued, are erroneous (see generally, Hatfield, Modern Accounting 1928; Reiter, Dividends, Profits and the Law 1926 iii).

109 Both the Lee and the Verner cases, did not concern depreciation proper. Lee involved depletion and Verner a decline in the market value of securities. In both cases, two concepts of depreciation were involved. In the Lee case, Davey QC used the term to mean a fall in market value-meaning depreciation is measured by the difference between the selling prices of the same asset at two different dates. In Verner, Buckley QC adopted the test of replacement (i.e., depreciation is measured by the difference between the present value of the old assets and the present value of a hypothetical new asset with which it could be replaced). These views of depreciation have been discounted by accountants. An objection of the market price test for example, is that, it is predicated upon the sale of an asset where no sale is really contemplated. As Piney J said in La Belle Iron Works v US, 256 US 377, 393 (1921):

There is a logical incongruity in entering upon the books of a corporation as the capital value of property acquired for permanent employment in its business and still retained for that purpose, a sum corresponding not to its cost but to what probably might be realized by sale in the market. It is not merely that the market value has not been realized or tested by sale made but that sale cannot be made without abandoning the very purpose for which the property is held...

110 See Yameh (1941) 4 MLR 273, 280.

111 See generally, R. H. Montgomery, Auditing, Theory and Practice, 4th ed (1927) 676; L.R. Dicksee, Depreciation Reserves & Reserve Funds, (1907) 6-7. These accountants argued that the purpose of depreciation allowances are the accounting period. The technique, the argument holds may result in a rough correlation with the annual fall in value, but the purpose is to probate operating costs and not record current values. See also, J. Gold, (1945) 6 U To L J 14, 47; [1889] 5 LQR 221; [1889] LJ 335; [1889] Accountant 89. Income Tax law also suggests the necessity for depreciation before any distributions or payments, see Naval Colliery Co Ltd v CIR (1928) 12 TC 1018, 1044.
appreciation. In so doing, they held that since it would be improper for a company to divide the unrealized appreciation of its fixed assets, the company should not be compelled to make any provision for depreciation.\textsuperscript{112} If this is the correct interpretation of the cases, then this may be misleading since the alleged relation between appreciation and depreciation is only valid if depreciation is interpreted to mean a fall in market value. Depreciation is not the converse of appreciation if used in the accounting sense, in which it means not a fall in value but an amortization of original cost.\textsuperscript{113}

While the common law approach to depreciation remains questionable, \textit{Re National Bank of Wales}\textsuperscript{114} is sometimes considered to have shaken the \textit{Lee & Verner} decisions. There, the liquidator of the bank issued a summons against a former director asking for a declaration that he was guilty of misfeasance or breach of trust in authorizing the payment of dividends from capital. The whole of the bank’s paid up capital had been lost due to debts owed. The debts were treated in the company’s balance sheet as good assets. Some large dividends were later paid to shareholders without any losses written-off or brought forward so as to diminish the profits of the next year. It was held that in each year, the circulating capital consumed in that year must be made good from receipts, but no allowance need be made for losses of fixed capital. Even here, the difference between fixed and circulating capital was still relevant and it is extremely difficult to determine precisely what was decided. However, by inference drawn from Swinfen Eady J who discounted the views of Lindley LJ in both the \textit{Lee & Verner} cases, he was of the view that some losses of fixed capital cannot be ignored and must be made good before distributing dividends.

This argument notwithstanding, it still remains highly questionable as to whether the distinction between fixed and circulating capital could be used adequately to reflect when a dividend made out of profits should be determined. Though controversy surrounds the common law approach concerning depreciation and dividend distribution, Australian

\textsuperscript{112} \textit{Lee’s case}, above at 22. See also, \textit{Verner’s case}, above n 25 at 258.

\textsuperscript{113} See, J. Gold, above at 111. Moreover, depreciation in the sense of exhaustion by wear and tear is a realized loss, which has always been misunderstood as was the case in \textit{Dowey v Cory} [1901] AC 477, 494; and therefore, cannot be the opposite of an unrealized gain. The common law courts have gone too far as to allow depreciation or losses to be written off against unrealized appreciation. It is difficult to see how this should be allowed.

\textsuperscript{114} [1899] 2 Ch 629.
courts and legislature continue to adopt that view, by not providing any legal obligation for depreciation unless a dividend is funded out of capital profits. However, since the Corporations Act does not preclude the use of capital profits in paying dividends, by implication, there is no provision for depreciation, meaning, the common law approach remains deeply rooted in Australia\textsuperscript{115} as reflected in *Australasian Oil Exploration Ltd v Lachberg*.\textsuperscript{116}

Accounting standards, do not however favour the procedure of declaring dividends without making provision for depreciation.\textsuperscript{117} Australian accounting standards are inconsistent with common law interpretation of profits under s 254T’s predecessors. They are more consistent with the s 294(3) of the *Corporations Law*, which allowed company directors to take into account any depreciable value in the assets of the company in the computation of dividends and profits. This view is consistent with English accounting standards and the current English Companies Act.\textsuperscript{118} This latter view which reverses the common law position, is to effect that, any asset with a limited economic life must be written down on a systematic basis over the course of its life to the residual value (if any). The writer supports the views of the Accounting standards with the effect that s 254T and the common law position do not reflect a reliable state of the law pertaining to dividend distribution.

\textsuperscript{115} See for example, *Phillips v Melbourne and Castlemaine Soap and Candle Co Ltd* (1890) 16 VLR 111; *Glenville Pastoral Co Pty Ltd* (in liq) v *FCT* 91(63)109 CLR 199, 207 where Kitto, Taylor and Owen JJ were of the view that, profits may, of course, be distributed by a company while a going concern even though a loss of paid-up capital previously incurred has not been made good.

\textsuperscript{116} (1958) 101 CLR 119, 133. In the joint judgment of the court which comprised Dixon CJ, McTiernan J and Taylor J it was said:

> It is necessary at this stage to refer briefly to one other argument which was advanced on behalf of AOE. This argument asserted that if a company engages in a transaction whereby it disposes, otherwise than in the course of its trading or business activities, of a single capital asset for a price in excess of the value at which that asset stands in its books, it may lawfully distribute the casual profits so made among its shareholders whatever the capital position of the company might otherwise be."

Contra the former s 294(3) of the *Corporations Law* which provides that company directors had to make adequate provision for depreciation.

\textsuperscript{117} Refer to International Accounting Standards (IAS) effects on profits. Cf the Australian Accounting Standard Board (AASB) 1010, “Accounting for the Revaluation of Non-current Assets” and AASB 1021, “Depreciation of Non-current Assets” which requires the depreciable amount of a depreciable non-current asset (that is one that has a limited commercial or useful life) to be progressively charged against profits and loss over its useful life.

\textsuperscript{118} See, *Companies Act 1985* (UK), s 275 (1) Sch 4, para 18; Accounting for Depreciation SSAP 12. The UK Jenkins Committee did also recommend legislation to require companies to make provision for depreciation (Jenkins Committee (1962) Cmd 1749, above n 38 paras 340 & 349).
Although s 254T does not mention 'capital', it is suggested that it be amended to the effect that any depreciation of assets must be taken into account in determining whether all of a company's paid-up capital is represented by assets. The effect of this proposal is that when depreciation is taken into account, it does not only assist in protecting creditors in the sense that the capital which is available for their protection is diminished by dividend but also consistent with the capital maintenance doctrine and international accounting standards. The current English approach\(^\text{119}\) as reflected by s 275 and the 'straight-line method' of determining depreciation, could be adopted in assisting our courts. Section 275(1) stipulates that since depreciation is usually charged to the profit and loss accounts and is treated as a realized loss which reduces the profits available for distribution. The “Straight line method” could be simply illustrated with a hypothetical example:

Suppose a company acquires a machine for $10,000 and estimates that it will have a useful life of 5 years and will have a nil residual value at the end of that time. On the straight-line basis, the company will charge a constant amount of depreciation ($2000) to its profits and loss account in each of the five years. If, in fact, the machine is sold for more than the amount by which it has been depreciated (for example if it is sold for $9,000 in the second year) the difference between the resale price and original cost less depreciation (i.e., $8,000) is a realized profit.\(^\text{120}\) There are probably very few businessmen who would not be surprised if told that in the calculation of the profits of their business they could ignore losses or expenses. There are probably even fewer accountants or economists who would accept the common law position.\(^\text{121}\)

\(^\text{119}\) Unlike the common law approach where depreciation is not taken into account in computing dividends, the 1985 Act (UK), s 273(1) requires that depreciation should be taken into account in determining the profits available for distribution. There was a similar approach under s 294(3) of the Corporations Law (Cth) (now repealed) where directors were required to make adequate provision for any depreciation in the value of its assets before declaring dividends out of profits.

\(^\text{120}\) This view is not dissimilar to that applied by the Delaware Corporations Law, ss 154, 170 & 244. According to s 170, if the capital of the company computed in accordance with ss 154 & 244 shall have been diminished by depreciation in the value of its property, or by losses to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes, the directors shall not declare and pay out of such net profits any dividends upon any shares until the deficiencies in the amount of capital represented by the issued and outstanding stock shall have been repaid.

\(^\text{121}\) Although generally accepted accounting principles somehow suffer from a lack of precision, and do not necessarily provide information critical to the basic legal inquiry of whether the corporation will be able to honour its liabilities after payment of a dividend in question, yet, Generally Accepted Accounting Principles (GAAP) are nearer to precision and could accurately identify likelihood of default on a consistent basis that statutes employing legal capital doctrines. (Refer generally to, L. D. Solomon et al, Corporations-Law and Policy 3rd ed, (1994) 259; J. Gold, "Fixed and Circulating Capital in the English Law of Dividends" (1945) 6 U. To L J 14. Arguably, for the capital maintenance doctrine to provide a meaningful regulation of distributions based on accounting practices, would require the development of a full scale jurisprudence of accounting which nearly everyone agrees, would be wholly impractical and a disaster (see, B. Manning and Hanks Jr, Legal Capital, 3rd ed) (1990) 66.
5.3.3. Realised and Unrealised Profits and Losses

Another question which was relevant in the formulation of the dividend rule turned on the question as to whether it is proper to include an unrealized increase in the value of a company's assets in the computation of the divisible profits. In *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* the issue in question was whether a company could allot to its shareholders shares credited as fully paid-up by way of capitalization of assets resulting from unrealized accretions to value of fixed assets. Buckley LJ expanded on the existing common law principles by holding that a dividend could be declared out of an unrealized accretion to capital.

Lord Clyde also went on to say that it would be illegal for the company to have distributed the amount in question, because, by law, an unrealized profit resulting merely from revaluation of fixed assets cannot be treated as a profit for dividend purposes, that this is not normally to be regarded as a wise commercial practice. Buckley LJ however, opined that if the surplus on capital accounts results from a valuation made in good faith by competent valuers, and is not likely to be liable to short-term fluctuations, it may properly be capitalized. His Honour intimated that there can be no reason why, if the valuation is not open to criticism, this should not be so, or even why, in any case in which the regulations of the company permit the distribution by way of profits on capital account, a surplus so ascertained should not be distributed in that manner. He then said:

> After all, every profit and loss account of a trading concern which opens and closes with a stock figure necessarily embodies an element of estimate. The difference between ascertaining trading profits by, amongst other things, estimating the value of the stock in hand at the beginning and end of the accounting period, and ascertaining capital profits by comparing an estimated value of the

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122 [1961] Ch 353. There, a company's constitution provided that the company might resolve that any sum standing to the credit of any excess of assets on capital account be capitalized and distributed by way of dividend. The company took out a summons to determine whether it had power under the article to allot to shareholders shares credited as fully paid up by way of capitalization of assets resulting from the revaluation (without realization) of the capital assets. (Alternatively, the court acknowledges that an unrealized profit arising from the revaluation of a fixed asset could also be used as a source of profit for a dividend, provided that the asset was not one which fluctuated in value over the short term and the company's paid up capital would still be represented by assets following the dividend. Preference shareholders opposed the capitalization. Their counsel referred to the decision of the Court of Session (Scotland) in *Westburn Sugar Refineries Ltd v Inland Revenue Commissioners* [1960] TR 105.

123 Ibid 371.

124 See, *Inland Revenue Commissioners v Thornton Kelley & Co Ltd* [1957] 1 WLR 482
assets with their book value, as appears to me to be a difference of degree but not of principle. Moreover, if a company has fluid assets available for payment of a dividend, I can see nothing wrong in it’s using those assets for payment of a dividend, and at the same time, as a matter of account, treating that dividend as paid out of a capital surplus resulting from an appreciation in value of unrealized fixed assets. The proper balance of the company’s balance sheet would not be disturbed by such a course of action. The company would be left with assets of sufficient value to meet the commitments shown on the liabilities side of its balance sheet, including paid up share capital.125

The decision in Dimbula may be at odds with the Scottish Court of Session decision in Westburn Sugar Refineries Ltd v Inland Revenue Commissioners,126 where in reaching the conclusion that unrealized profits are not distributable as dividends, Lord Clyde stated:

“...in the case of an appreciation which is neither realized nor immediately realizable, it would be illegal to distribute the surplus”.

The decision in Dimbula Valley has been followed in Australia. Needham J in Blackburn v Industrial Equity Ltd127:

If the question needed to be decided in these proceedings, I would follow Buckley J in Dimbula Valley in preference to the Court of Session in Westburn Sugar Refineries. I would leave open the question whether a distribution of profit was permissible where it arose from a selective or incomplete revaluation of a company’s assets. In such a case, it may be that other assets shown in the accounts at book value would need to be devalued and such depreciation set against the appreciation of other assets revalued.128

In the determination of unrealized capital profits for dividend purposes, the International Accounting Standard (IAS) which Australia has adopted prohibits the revaluation of non-current asset except as part of a revaluation of the class of non-current to which it

125 [1961] 1 Ch 353, 373.  
126 [1960] SLJ 297. Lord Clyde’s view in this decision was reinforced by Lord Sorn, who surmised the position: “capital profits are not distributable until they are realized” The Court of Session held that a reserve fund constituted as a result of a revaluation of unrealized fixed assets could not legally be distributed.  
127 (1976) 2 ACLR 8 at 16. Applied in Industrial Equity Ltd v Blackburn (1977) 137 CLR 567 at 572 per Mason J. In effect, it was said in Blackburn, that a dividend could not be paid based on a partial revaluation of assets. Cf Australasian Oil Exploration Ltd v Lachberg (1958) 101 CLR 119, 133. There, the court held that a realized profit on the sale of a capital or non-circulating asset could be used to fund a dividend, if the value of other assets of the company exceeded the value of it’s paid up share capital. See also, Marra Developments Ltd v BW Rufe Pty Ltd [1977] 2 NSWLR 616, 629.  
128 (1976) 2 ACLR 8, 16. In Industrial Equity, (Ibid), Glass JA, is also taken to have accepted the reasoning of Buckley J as correctly stating the law. Industrial Equity was followed by the New Zealand case of Re New Zealand Flock & Textile Ltd [1976] NZLR 192 per Beatie J. (There, a company was able to pay dividend out of unrealized capital gain).
Chapter 5 5.3. Principles Determining Dividends

The writer is opinion that the views of the accountants and the decision in *Westburn Sugar*, provide a suitable approach. The *Westburn* approach is significant because it prevents the payment of cash dividends out of profits not yet realized or out of surplus resulting from padding the accounts by estimates and conjectures on an unrealized increase in the value of assets. This view, which is also consistent with the *Delaware* and *California Corporations laws*, prevents the payments of dividends from fictitious accounts.\(^{130}\) Though it is a difficult question in accounting and in law as to how assets are to be valued and as to when profits are to be regarded as having been realized, the courts in most situations, should be satisfied with recognized accounting practices.\(^{131}\) The judicial and statutory approach in Anglo-Australian law of permitting share dividends on the basis of surplus arising from unrealized appreciation is very unsound and may be very misleading.

The purpose of a dividend restriction is not to furnish a guide as to the advisability of a dividend distribution, but to establish some minimum test of whether the financial condition of a corporation forbids a dividend, having in view the safety of creditors and the interests of the different classes of shareholders as to the integrity of their investment.\(^{132}\) The better position in a summary would be that s 254T is amended to the effect that depreciation of assets be treated as a realized loss and therefore taken into account before dividends are declared. Accumulated realized losses from past years must also be taken into account before a dividend can be declared from a current year profit while unrealized profits on a revaluation of fixed assets are distributable only to the extent that they exceed the amount written off for depreciation. Unrealized profits may not be applied in writing off realized losses. However, a solvency test is best preferred.

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\(^{131}\) This was the view taken by American courts in *Southern California Home Builders v Young*, 45 Cal App 679 (1920); *Kingston v Home Life Insurance Co of Am*, 11 Del Ch 258 (1917).

Chapter 5  

5.3. Principles Determining Dividends

The effect of this suggestion would be to update the somewhat convoluted rules of the common law so as to bring the law on dividends closer to international accounting practices. The common law position that dividends may be declared from unrealized increases in fixed capital should be discarded, because it remains very unsatisfactory. The increase in value is but a book entry for which no funds are forthcoming to the company to facilitate the payment of a dividend. The accounting profession has long treated this as an anomaly which goes against well established principles of accountancy.

5.3.4. Payment of dividends from current years trading profit despite past losses.

Judicially formulated principles on the law of dividends suggest that a method of ascertaining profits for dividend purposes is that a net trading or revenue profits in a particular accounting period may be used to fund a dividend. Accordingly, a trading loss made in a previous accounting period does not have to be made good before a trading profit in the most recent concluded trading period is distributed as a dividend. In *Ammonia Soda Co Ltd v Chamberlain*, a manufacturing company incurred trading losses for several years before becoming profitable. The directors set off the losses against an appreciation of the company’s capital assets as ascertained by a certain valuation and, as approved in a general meeting.

They proposed to pay dividends out of subsequent profits without any further provision for past revenue losses. The plaintiff shareholder argued that no profits were available until such losses had been made good. However, the court held that a company which has operated at a loss and thus accumulated a deficit on its revenue account may distribute revenue profits of later years without either making good any part of the

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133 See, the Lee’s case, above n 22 and Verner’s case, above n 25.
134 This method was initially considered in *Dent v London Tramway Co* (1880) 16 Ch D 344. Where the question was: “May companies declare dividends out of profits of a particular year despite past losses?” See also, *Re National Bank of Wales Ltd* (1899) 2 Ch 629 and the views taken by Jessel MR & Wright J, above notes 14-15 at 4-5 (and accompanying text).
135 (1918) 1 Ch 266. The principle established here was that revenue losses incurred in prior periods would not have to be made good before a dividend could be declared from profit of the current period.
136 According to the views of the directors, no capital had been really lost, and they were of opinion that the value of the land and works as a going concern had been increased, as a result of their boring and exploration work (at 290).
137 The plaintiff shareholder invited the court to lay down that whenever there was a debit to the profit and loss account, irrespective of the way in which it arose, of the stage in the company’s operations, and of the nature and business of the company, it was illegal to divide profits subsequently earned without first writing off out of those profits the amount of the debt (at 289).
Chapter 5  5.3 Principles Determining Dividends

accrued loss or canceling the loss by reducing it's paid up capital. By this therefore, the
law sanctions the view that the revenue account is not a continuous account. Swinfen
Eady LJ considering the plaintiff's argument as very unsound said:

The Companies Acts do not impose any obligation upon a limited company, nor does the law
require, that it shall not distribute as dividend the clear net profit of its trading unless its paid up
capital is intact or until it has made good all losses incurred in previous years...  

The above view was adopted and applied in Australia in Marra Developments Ltd v BW
Rofe Pty Ltd. This was an appeal against a declaration of Shepperd J concerning the
payments of dividends under former s 376(1) of the Uniform Companies Act 1961.
Although the case turned on the construction of the word 'payable' as used in the Act, it
also concerned the question as to whether a company that has made a trading loss in the
current year, could declare a dividend against prior undistributed trading profits. If so,
what does this signify for the continuity of the revenue account under Australian law?
Hutley JA, said:

The true construction of the words 'payable' ...out of profits' in s 376(1), in relation to the
payment of a final dividend, do not predicate the existence of a segregated fund from which the
profits are to be extracted for the purpose of the distribution; they simply require that, at the date at

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138  (1918) 1 Ch 266 at 283. (Warrington and Scrutton LJJ delivered concurring judgments). In their joint judgment,
they reverted to the earlier cases embodying principles of old law that losses of circulating capital, must be made
good, losses of fixed capital could be ignored before dividends are paid. Peterson J also said: "Where a company
made losses in past years and then makes a profit out of which it pays dividends... such a dividend is not paid out
capital. If it were, the paid up capital would be still further reduced by the payment. In fact, the assets
representing the paid-up capital remain the same or of the same value as before the payment of the dividend".
(One commentator, remarking on Peterson J’s decision said: “This ingenious argument, which places the results
of each period’s trading into watertight compartments, virtually means that any item of loss is irrelevant to the
size of the dividend fund except in the period in which it is incurred” (see, B. S. Yameh, [1941] MLR 273, 285).
Cf, also the views of American commentators who discount the traditional English approach, (especially, Hatfield,
Modern Accounting (1928); Reiter, Dividends, Profits and the Law (1926) iii).

139  [1977] 2 NSWLR 616 at 630. The legal proposition enunciated here was that if a trading profit was not distributed
in the year in which it is made it could be carried forward and used for a dividend in the later year, without
offsetting a trading loss. Our courts in accepting that dividends may be paid from current trading profits despite
past losses argued in Philips v Melbourne & Castle Main Hose Co Ltd (1890) 16 Vic LR 111, 113; that so long
as a company pays its creditors there is no reason why, in an apparently flourishing concern, it should not go on
and divide profit though every shilling of the capital may be lost. Notwithstanding the nature of the approach
taken in Marra Development, a director of the company who authorizes a payment of dividends when the nature
of company’s business and the amount of a prior loss was so imminent that the loss was to be taken into account,
the court may hold a director liable for breach of fiduciary and statutory duties under as 180-184. That aside,
preventing abuse. If directors were to manipulate the dividend policy to serve their own selfish interest rather than
those of the company that would amount to breach of their fiduciary duties but, it does not suggest they would
mitigate the relevant conflicts of interest involved when distribution has been made to shareholders.

140  See, Re Howie & Co Ltd [1904] 2 Ch 208.
which the dividend is declared, the profit and loss account of the company shall disclose profits out of which the dividend can be paid.  

In giving judgment as to the legal question posed above, Hutley JA, citing a line of cases, intimated that a dividend could be declared out of current profits without the restoration of lost capital. He put it this way:

In determining whether a dividend is payable out of profits, events between the end of the financial year and the date of declaration of the dividend cannot be regarded, unless they are such as to demonstrate that the accounts which disclosed the profits are false. It is in respect of the period of account, and that period alone, that the question whether there are profits out of which a dividend may be declared must be determined.

It is arguably difficult to accept these old decisions, as they are bound to mislead. The approach adopted above, leaves out of account changes in the value of assets not consumed or turned over in the course of the company’s business; also left out are gains realized or losses incurred on the sale of any assets of that kind, and expenditure not set off against revenue receipts. In Ammonia Soda, for example, Swinfen Eady LJ did not clearly illustrate how the plaintiffs’ argument was unsound.

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141 [1977] 2 NSWLR 616, 617. It would have made no difference if Hutley JA was to give a similar meaning to the word ‘paid’ as used under the current s 254T of the Corporations Act 2001. The language would have arguably remain the same.

142 For example, in Lee v Neuchatel Asphalt Co (1889) 41 Ch D 1 (In this case, it was said a dividend may of course, be based upon the revenue profit of the then current, or last concluded, period, even though the company has previously lost and replaced its fixed capital; and even where it has lost all of the subscribed capital—i.e., trading or revenue profits would be able to be used to fund a dividend, even if there was a deficiency in the capital account). In Ferner v General & Commercial Investment Trust [1894] 2 Ch 239 at 264, it was said that a dividend could be declared out of revenue profits of the current period, even if the company has lost all of its subscribed capital. In Glenville Pastoral Co Pty Ltd (in l i q) v Com of Taxation (1963) 109 CLR 199, 207, the view is generally that, it is not necessary that capital losses be recouped before such revenue profits can be used to base a dividend. That, a company may base a dividend upon the revenue profits of such a period, even though it has in previous periods incurred revenue losses and those losses have not been recouped and, therefore, represent a loss of capital.

143 [1977] 2 NSWLR 616, 618. The common law principle adopted here is that trading loss made in a previous accounting period does not have to be madder good before a trading profit made in the most recent concluded trading period is distributed as a dividend. Mahoney JA spiced up the opinion by saying that “it is not necessary that profits be available at the date when a dividend falls to be paid, nor if they are not, and the payment is made will this result in the payment out of capital. Rather, the debt owed by a company to its shareholders, after a dividend has been declared, is to be assimilated to that which it owes to its ordinary creditors...A company’s accounts and financial statements will reveal whether it has made a profit or incurred a loss in a particular accounting period” This view was also applied in QBE Insurance Group Ltd v ASC (1992) 38 FCR 276; 10 ACLC 1490.

144 In financial and accounting milieu, it is the norm that sound accounting practice would require that past trading losses be made good before a dividend is declared.

145 This method which looks only to trading revenue and trading expenses is arguably not a reasonable and satisfactory method of determining when dividends are available for distribution out of profits. At least, those items left out above would have to be taken into account for provide a realistic view of the determination of profits.
Rather, he averted to the misconceived notion of the abstract nature of the distinction between fixed and circulating capital, terms which accountants and economists have not considered to be a suitable measure of business life. The terms fixed and circulating capitals were taken over by the courts from the writings of the economists. Even from the economists from which the courts borrowed these terms, there have been mixed views and no uniformity of approach, and no justification can be found for the doctrine itself in the works of economists. This is so because, for the economists, there can be no profits until allowance is made for the depreciation or loss of fixed as well as circulating capital. Since Adam Smith drew the distinction, economists have never been able to define much more precisely what the line of demarcation is. It is ironical for courts to do so.

The position adopted in *Marra Development* which remains the current law under s 254T is more complicated where that which is relied upon to base a dividend is, in whole or in part, profits which were derived in previous trading periods. Although the availability of profits from previous trading periods as a basis for declaration of a dividend may be affected by the way in which the company has elected to treat them, if the capital maintenance doctrine is to be strictly adhered to and creditor protection the dominating factor, then the approach of distributing dividends from current year’s trading profit without making provision for past losses, remains a very crude mechanism for creditor protection. This approach, it may be argued, is based on a fallacious concept of capital as a res rather than a quantum or measure. There is the argument that the courts seem hopelessly ‘thing-minded’ in their ideas about capital. If this view is correct, then capital

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146 The Economists whose influence have been expressly acknowledged are; Adam Smith, A. Marshall, *Wealth of Nations* (1937) 262-263; J. S. Mill, *Principles of Political Economy* (1896) 62.


148 Adam Smith, above n 147 at 50, 96, 271.

149 For example, a company may elect to distribute the profits derived in its current trading period; it may carry them to a reserve or, it might decide to capitalize them; see, *Federal Commissioner of Taxation v Miller Anderson Ltd* (1946) 73 CLR 341, 367.

150 See, *Verner’s case*, n 25 and the statement made there by Lord Lindley.
Chapter 5

5.3. Principles Determining Dividends

cannot be considered as any res or ‘money subscribed’ but consists of an amount of net assets equal to the amount of the legal capital.\footnote{See, H. W. Ballantine, “Corporate Capital and Restrictions upon Dividends under Modern Corporations Law” (1938) 22 Col LR 229, 253. See also, Lubbock v British Bank of South America [1982] 2 Ch 198 at 202; Isaacs, “Principal Quantum or Res?” (1933) 46 HLR 776.}

No matter what guidance this argument may provide, it is not suggested to be a sound criticism underpinning the concepts of dividends and profits. Lawyer-economists and accountants have wobbled in their language between capital as a res or quantum. This makes little difference to the already clouded distinction between fixed and circulating capital. Since the determination of dividends and profits from the fixed and circulating capital distinction has proven to be more problematic, another distinction in the shape of capital as a res or quantum will even be more complicated and difficult in application.\footnote{For a detailed discussion and complexity in reconciling either the res or quantum theory of capital, see, Isaacs, (ibid).}

Moreover, the Marra Development approach remains very unclear, imprecise and inconsistent to the extent that, though past losses may not be made good before the payment of dividends, yet, undistributable profits may be carried forward to a subsequent accounting period and used for dividend purposes after a trading loss in a subsequent accounting period has been offset against the accrued trading profits before a dividend is declared.\footnote{Refer to, Re John Fulton & Co Ltd [1932] NI 35.}

The principle that dividends may be paid from a current trading period without making good past trading profits, has proved to be unsatisfactory even in its jurisdiction of origin.\footnote{Objections of financial policy have been raised by some authorities to the relaxation of permitting dividends from current annual profits of prosperous years when the total results of operations in previous years at the time of making the dividends show a deficit (see, generally, Samuel, Shareholders’ Money (1933) 145-149; Hatfield, Accounting (1931) 270-271). Professor Hatfield, an eminent US accounting authority who has devoted much attention to dividend questions, admits that circumstances may justify the payment of dividends from the Marra Development approach especially, in circumstances of when the company is a wasting asset or liquidating concern. The basic principle of the wasting assets doctrine, which permits dividends regardless of the existence of profits or annual net profits, has never been clearly formulated because of the origin in the fallacious concept of capital by the English courts as a res rather than a quantum.}

In light of shortcomings in the common law rules with respect to payments of dividends to shareholders, principally on the grounds that these are often commercially unsound with the concepts of capital and profits in 1962, the Jenkins Committee recommended that the law should be changed to require that past revenue losses be
eliminated before profits of subsequent years be distributable. The Committee also frowned at Swinden Eady LJ’s view in Ammonia Soda, which requires a company’s financial position to be regarded in isolation to its overall position. The Jenkins Report suggested that a company’s revenue account be recognized as a continuous account. This was adopted in the UK and is now inserted as s 263-275 overruling the unsatisfactory decision of the English Court of Appeal in Ammonia Soda. American courts have also refused to follow the common law and Australian position.

Rather, their approach is consistent with the current English position which requires that past trading losses be deducted from current trading profits before dividends are paid to shareholders. While the current Anglo-American approach reflects a detailed code of statutory rules governing some of the circumstances when dividends may be declared, it would have been suggested that section 254T be amended and the decision in Marra Development modified, in similar manner to those contemporary positions, especially as concerns the question of the appropriateness of the relevant accounting periods for the distributing of dividends. So much so that, a possible amendment to s 254T could be made if the English dividends law could also adequately and comprehensively define the term ‘profit’.

The absence of a universally acceptable meaning of the term ‘profit’, and the uncertain nature still prevailing as to the source of fund out of which dividends could be declared out of profits may render the English and American approaches not to be an adequate model for possible adoption in Australia. The deficiencies in the law would still remain. One caveat is relevant, both the current English approach and accounting practices provide the optimum approach which requires provision for depreciation before dividends can be declared and paid.

155 Jenkins Committee, above n 38, 341.
156 The current English position reverses the common law approach to the effect that, losses incurred in previous years, so long as not previously written-off, must be taken into account in determining the amount of distributable profits.
158 Ibid.
5.4. Some Policy Problems (Definition of Profit)

5.4.1. Problem of Defining Profits

Section 254T requires dividends to be paid only out of the profits of the company. However, the Corporations Act has not yet given any specific guidance as to what are profits, leaving the matter to the general law and evidence of accountants as to commercial practice. Though the term ‘profit’ has received some judicial explanation, this has not been comprehensive. Section 263(3) of the English Companies Act defines profits of a company which are available for distribution as:

Its accumulated realized profit, so far as not previously utilized by distribution or capitalization, less its accumulated realized losses, so far as not previously written off in reduction or reorganization of capital duly made.\(^{159}\)

5.4.1.1. Judicial Explanations.

There was some early judicial reluctance to define ‘profits’. In *Lee v Neuchatel Asphalte Co.*,\(^{160}\) Lindley LJ said:

There is nothing at all in the Acts about how dividends are to be paid, nor how profits are to be reckoned. All that is left and very judiciously and properly left to the commercial world. It is not a subject for an Act of Parliament to say how accounts are to be kept, what is to be put in a capital account, what into an income account, is left to men of business.\(^{161}\)

Similarly, in *Verner v General & Commercial Investment Trust Ltd*,\(^{162}\) Lindley LJ put it:

It has been already said that dividends presuppose profits of some sort and this is unquestionably true. But the word ‘profit’ is by no means free from ambiguity. The law is much accurately expressed by saying that dividends cannot be paid out of capital than by saying that they can only be paid out of profits.\(^{163}\)

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\(^{159}\) The 1985 Act, however, makes no distinction between revenue profits and losses (i.e., profits and losses from trading) and capital profits and losses (i.e., profits and losses on the disposal of fixed assets) for this purpose. However, Accounting Standards and related materials amplify the concept of ‘realized’ profits and losses. (See The Determination of Realized Profits and Disclosure of Distributable Profits in the context of the Companies Act; (ICAEW Accounting Recommendation) (Sept 1982); Disclosure of Accounting Policies SSAP2, Statement of standards help to define ‘realized profits’ but may not be decisive in this respect (see, R.S. Nocks, "Illegal Dividends, Part I" (1997/8) RALQ 75, 89-96).

\(^{160}\) (1889) 41 Ch D 1.

\(^{161}\) Ibid at 21.

\(^{162}\) (1894) 2 Ch 239.

\(^{163}\) Ibid. 266.
Further, in *Dovey v Cory*, Lord Macnaughten said:

I do not think it desirable for any tribunal to do that which Parliament has abstained from doing; that is, to formulate precise rules for the guidance or embarrassment of businessmen in the conduct of business affairs.\(^{165}\)

The courts’ explanation of profits as deduced from the cases above, which is based on the res theory of capital, may be misleading.\(^{166}\) They tend to assume that if the company did not divide the shareholders’ subscriptions or the assets in which they had been invested, there was no violation of the rule prohibiting a return of capital. The courts then drew the inference that whatever was not a return of capital constituted a division of profits.\(^{167}\) This reasoning is resorted to in order to justify the rule that all previous losses of capital may be ignored. Although this follows easily enough from the res theory of capital, since there is no middle terrain between capital and income,\(^{168}\) some judges have been embarrassed by the sweeping definition of profits which they are left to adopt. The result has been that a certain degree of doubt has been cast upon the rule that dividends are paid only from profits. Lindley LJ must have been correct when he said: “the law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that dividends can only be paid out of profits”.\(^{169}\)

The issue as to what is profit is detailed upon by Fletcher Moulton LJ in *Re Spanish Prospecting Co Ltd*.\(^{170}\) This was an appeal from a decision of Swinfen Eady J on the question as to whether certain amount of money was to be profit which was relevant to be distributed. Gore-Browne KC and Clauson, for the appellant, contended that when a

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\(^{164}\) [1901] AC 477. When the English courts use the word “profit” in connection with dividends, no peculiar corporate phenomena are envisaged. The judges who said profits were not thinking of balance sheet surplus. Profit means annual profit-the sense in which it was used with reference to unincorporated business. The judges found it hard to conceive of profit in any other sense and no decision has required a different interpretation. (Cf Lord Davey’s remarks in *Dovey v Cory* [1901] AC 477. Davey was opposed to regarding profits as dependent solely on the results for each year, but took it for granted that such was the prevailing attitude in the lower courts.

\(^{165}\) Ibid at 488. A similar position was upheld in Australia, in *Stevenson Hardy & Co Ltd v Smith Wylie (Aust) Ltd* (1939) 39 SR (NSW) 388, 400.

\(^{166}\) For a detailed discussion of the res theory and quantum theory of capital, see, J. Gold, (1945) 6 U TO LJ 14, 42-43.

\(^{167}\) Refer to the Lee’s case, above n 87 and the Verner case, above n 88.

\(^{168}\) Cf *Lubbock v British Bank of South America* [1892] 2 Ch 198, 202; *Down v Gaukon British Picture Corp Ltd* [1937] Ch 402.

\(^{169}\) See, Lee’s case, above n 87. It is noteworthy that s 245T does not reflect the common law position which required dividends to be paid out of capital.

\(^{170}\) [1911] 1 Ch 92. The case turned upon the meaning of the word “profit”.
partnership business has to be wound-up and all debts paid, and each partner has been repaid what he or she has brought in as capital, then any balance that is left is ‘profit’.\(^{171}\)

Fletcher Moulton LJ elaborated upon the meaning by saying:

The word ‘profits’ has in my opinion a well defined legal meaning, and this meaning coincides with the fundamental conception of profits in general parlance, although in mercantile phraseology the word may at times bear meanings indicated by the special context which deviate in some respects from this fundamental signification.\(^{172}\)

His Honour continued:

Profits imply a comparison between the states of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates... If the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance of course being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the periods in question.\(^{173}\)

The above passage was cited with approval by Gibbs CJ in *Slater Holdings (Federal Cmr of Taxation) v Slater*\(^{174}\), where Mason, Breman and Deane JJ agreed with the judgment of the Chief Justice, though the Chief Justice qualified his agreement by saying that the passage is not of universal application and each case must depend upon its own circumstances. He preferred to take the definition of Fletcher Moulton LJ as a guide.\(^{175}\)

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\(^{171}\) See, *Bishop v Smyrna & Cassaba Rly Co* [1894] 2 Ch 265.

\(^{172}\) [1911] 1 Ch 92, 98. Fletcher Moulton LJ’s statement was adopted in Australia in *FCT v Slater Holdings Ltd* (1984) 156 CLR 447, 460. In these cases, profit was stated to be any net increase in the total assets of a business between the beginning and the end of a particular accounting year.

\(^{173}\) [1911] 1 Ch 92, 98-99. A similar formulation was provided in *QBE Insurance Group v ASC* (1992)10 ACLC 1490, 1505. There, where a company’s assets exceeded its liabilities, the excess was taken to represent profits to the extent that it does not represent share capital. Lockhart J was called upon to rule on certain paragraphs of approved accounting standard AASB 1023 which required insurance companies to appraise their investments at the net market values as at balance date. The effect of this was to require insurance companies to compute for any change in the valuation as a revenue or expense item in their profit and loss accounts. His Honour said: “The statement of principle that profit should be calculated by reference to changes in the value of assets of a business during the relevant financial period in *Re Spanish* is as valid today as it was in 1911 when expounded”.


\(^{175}\) *Re Spanish Prospecting*, above n 170 was distinguished in *Blackburn v Industrial Equity Ltd* (1976) CLC 40-267 at 28,717. It was referred in *Marra Developments*, above n 70.
The expression of the word ‘profit’ used in *Re Spanish Prospecting* can be used together with acceptable accounting standards to shape the meaning of profits.\textsuperscript{176} However, reliance on the decision alone would be an inadequate explanation of the term profit. The approach used only refers to the amount of gain made by a company between two specific dates. This raises the question of whether to include gains or losses not directly connected with the routine conduct of the company’s business, such as a rise in the value of a company’s factory freehold.\textsuperscript{177} The approach of looking at profits is inconsistent with the capital maintenance doctrine which is concerned more with creditors who would not want to be prejudiced by returns of capital to shareholders. Shareholders are also adversely affected by the *Re Spanish* explanation of profits, especially in a company with different classes of shares. Preference shareholders, who have priority for a return of capital, would be prejudiced if there was a disguised return of capital to ordinary shareholders.\textsuperscript{178} Generally, the approach taken by Fletcher Moulton LJ in *Re Spanish Prospecting* based on comparing the value of assets at the time of commencement and conclusion of accounting periods remains inexact taking into consideration, cases such as *Lee* which support the view that accountants did not always revalue fixed assets on sale.

Also, the measurement of profit by considering only the increase in the total assets of the company over a period of time has remarkable difficulties. First, it does not deal with whether losses of previous periods are to be taken into account nor does it take into account fluctuations in the value of retained assets. Secondly, it fails to identify the assets which could be used to fund the payment of dividend and lastly, there is no method provided for valuing of assets. Fletcher Moulton’s formulation may also be inconsistent and even more difficult in Australia dividend law. This is reflected in the decision of Mahoney JA in *Marra Developments Ltd v BW Rofe Ltd*,\textsuperscript{179} where his Honour gave a detailed consideration to the meaning of profits.

\textsuperscript{176} In *Re Spanish Prospecting*, (Ibid), Fletcher Moulton LJ went on to refer to how the comparison of assets could be made. There would have to be due allowance of any capital introduced into or taken out of the business in the period.

\textsuperscript{177} This argument is more consistent with the writers of Fords Company Law (see, Ford et al, *Ford’s Principles of Corporations Law* 12\textsuperscript{th} ed (2005) para 18.130 at 811).

\textsuperscript{178} Despite defects in the *Re Spanish case*, the statement of Moulton Fletcher L.J has been adopted by later cases as the correct one for providing a meaning to the term profit.

\textsuperscript{179} [1977] 2 NSWLR 616
including, that which is available for dividend purposes. There, it was suggested that dividends could be declared out of a trading profit in a particular year without allowance being made for the depreciation of fixed assets.\textsuperscript{180} In one of his early editions Professor Ford,\textsuperscript{181} criticized the \textit{Re Spanish} method as being ‘too crude’. He said:

\ldots It fails to distinguish between, on the one hand, trading gains in the value of assets which are due to trading activity of the company (such as gains made by buying and selling stock on advantage terms) and, on the other capital gains in the value of fixed assets which have been required to be held rather than for constant turnover. Moreover, it would count as profit an unrealized gain on a fixed asset and, conversely, a decline in value of such an asset would reduce profits.\textsuperscript{182}

\subsection*{5.4.1.2. Accounting and other Explanations.}

The term ‘profit’ in general, is one having a wide scope according to the context in which it has been used and is not limited to the Corporations Act’s conception of the term.\textsuperscript{183} However, it is not entirely clear what is the relationship of the accounting standards or taxation law\textsuperscript{184} to the definition of profits for the purpose of s 254T.

\textsuperscript{180} The \textit{Marra Development} decision reflects the inconsistencies and inexactness of the concept of profits. The decision attracted the Simplification Task Force to suggest that the decision was unclear, uncertain and no longer relevant yet, serving to thwart the efficient operation of the law. (See, Simplification Task Force Plan of Action, \textit{Company Law Simplification Program} (1993) at 2. The Task Force acknowledges in its proposal that, "which ever source (profits or capital) is used to pay dividends should not be so important". (Simplification Task Force, \textit{Corporations Law Program-Share Capital Rules Proposals for Simplification} (Nov 1994) at 10). Unfortunately, and though this proposal was not adopted, the Task Force did not provide any guidance as to how profits may be defined and determined. While the judicial explanation remained inadequate, certain relevant points can be distilled from the case law: (i) Profits imply a comparison between the states of a business at two different dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates. See Fletcher Moulton LJ in \textit{Re Spanish Prospecting Company} [1911] 1 Ch 92, 98. See, \textit{Mastercard v FCT} (1984) 16 ATR 77. Lord Russell in \textit{Hill v Permanent Trustee Co of NSW} [1930] AC 720, 731, said: "A Limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payment made by it by means of which it parts with money to the shareholder can only be made by way of dividing profit". (ii) the question whether there are profits available for distribution is to be answered according to the circumstances of each particular case and the nature of the company: \textit{Bond v Barrow Haematite Steel Co} [1902] 1 Ch 353, 365-367. See also, \textit{QBE Insurance Group v ASC} (1992) 10 ACLC 1490 (iii) there is no need for accounts, formal or informal, to be drawn up in respect of an accounting period before a dividend can be paid out of profits: \textit{MacFarlane v FCT} (1986) 67 ALR 624, 13 FCR 356.

\textsuperscript{181} HAJ Ford, \textit{Ford’s Principles of Corporations Law}, 6\textsuperscript{th} (ed) (Sydney: Butterworth’s, 1992) para 1009.

\textsuperscript{182} Ibid.

\textsuperscript{183} \textit{MacFarlane v FCT} (1986) 67 ALR 624.

\textsuperscript{184} In a particular context, such as income tax context the explanation as to what is profit is narrowed to exclude, in substance, profits arising merely from an increase in value of fixed capital assets and has been limited to revenue profits: see, \textit{Russell v Town & County Bank Ltd} (1888) 13 App Cas 418, 424. Also, for taxation purposes, the existence of profits does not depend on their recognition in the books of the company. (See, Latham CJ in \textit{Dickson v FCT} (1940) 62 CLR 687, 705. For the purpose of company law, the term has not been given the restricted meaning, which generally has been applied to it in the income tax law. Revenue profits in company law, are of course, profits for the purpose whether a revenue profit has been derived must be determined by reference to a
Chapter 5

5.4. Some Policy Problems (Definition of Profit)

One view point from accounting milieu is that when s 337 provides that a standard is to be interpreted subject to the Corporations Act, there is an implication that a standard that requires a company to do something which would infringe the guidelines about distributable profit must give way to those guidelines. This was the argument in *QBE Insurance Group Ltd v ASC.* There, the case concerned Accounting Standard AASB 1023 (now in its revised form as AASB 1023), which required a general insurance company to bring to account unrealized gains and losses on investments at net market value, irrespective of whether the investments are short or long term and whether the gains are clearly real and permanent.

It was argued that if the accounting standard were complied with, the company’s profit and loss account would disclose as profits an amount different from the legal profit which s 254T allows to be distributed as dividend. Lockhart J held that the AASB 1023 was consistent with the common law approach to profits revealed in *Re Spanish Prospecting,* though he recognized that the law allows another approach to the calculation of profits. He distinguished cases which indicated that an unrealized accretion of the value of a fixed asset cannot be available to support a dividend unless the accretion is of a permanent character, on the ground that those cases related to ‘fixed capital’, whereas, “AASB 1023” deals with investments which are ‘circulating capital’.

Since the common law guidelines are not legal definitions in the ordinary sense because courts rely

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186 *Evans v Deputy Commissioner of Taxation (SA)* (1936) 55 CLR 80,101 (where it was held that any account representing the whole or part of such excess, other than the share capital account, is an account of profits). This view is also generally in accordance with the approach adopted by the Federal Court in *Sun Alliance Investments Pty Ltd (in liq) v FCT* [2003] FCA 75.

187 Although profits and loss accounts can be guidelines for defining profits, they are not adequate indications of what will be paid as dividends. Their primary purpose is to report on the results of the company for the relevant period, and in particular the results of its operations during that period. (See, *QBE Insurance,* above n 188 per Lockhart J.

188 The AASB 1023 is must be noted regarded the assets in question to be circulating capital. If correct, then, the AASB 1023 did not apply in the particular scenario.
5.4. Some Policy Problems (When Must Profits Exist)

upon the opinions of accountants, a point may be advanced to the effect that certain of the judicial guidelines could be read subject to the Australian Accounting Standards Board, (now, International Accounting Standard) in influencing and shaping the concept of profit as used by s 254T.\footnote{This position also receives support from some commentators. See, Ford et al, \textit{Ford's Principles of Corporations Law}, 11th (ed) (2003) at 812. In the United Kingdom, s 263(3) of the \textit{Companies Act 1985} has afforded some guidelines on how profit may be ascertained. It, however, recognizes the view of accounting practices and builds on the accounting requirements to shape s 263. Sections 270-276 also contain accounting provisions that must be met before dividends can be distributed from profits. The provisions require that the amount for distribution should come from profits, losses, assets and liabilities, share capital and reserves, the balance sheet, and profits and loss accounts which are properly audited and which must present a true and fair view. These are complimented by stock exchange listing rules. The objectives of the accounting standards and sections 263-276 are two fold: (i) to ensure that creditors are not prejudice by the distribution to shareholders of funds that are not properly to be regarded as part of the company’s capital buffer; (ii) to ensure that the fact that creditors are not prejudiced is suitably evidenced by the company’s accounting which is assumed provides a cushion for the protection of creditors.} Although this view has some merit and supported by the writer, the accounting profession is not united on this issue given the different possible interpretations that present themselves with respect to the relevant accounting standards.\footnote{See, generally, R. Chambers, “Accounting and Corporate Morality: The Ethical Cringe” (1991) 1 \textit{ALCL} 9; R. Chambers & P. Wlonez, “A True & Fair View of Financial Position” (1990) 8 C &SLJ 353.} The fact that a dividend payment out of profits embodies aspects of the provisions governing a reduction of capital,\footnote{See \textit{Corporations Act 2001} (Cth), s 256 and s 257 (buy-back).} and considering that the concept of profits remained too problematic to be clearly defined or determined with precision, it is suggested that to remove the technical difficulties involved in defining profits, the law can be replaced by a solvency test.\footnote{A detail analysis of this approach is provided below, at section 5.6. which suggest an optimum approach for regulating distribution. The solvency requirement re-asserts the validity of Gower’s first principle relating to dividends, to the effect that dividends should not be paid to shareholders if this would affect the solvency of the company (i.e., dividends cannot be paid if this would result in the company being unable to pay its debts as they fall due). (Refer to, one of his early editions, L. C. B. Gower et al, \textit{Principles of Company Law} (1992) at 243-244.}

5.4.2. When Must Profits to fund a Dividend Exists?

In the interpretation of section 201 of the \textit{Corporations Law}, it was held in \textit{Industrial Equity Ltd v Blackburn}\footnote{See, \textit{Industrial Equity v Blackburn} (1972) 2 NSWLR 616 at 622 per Mahoney JA. Where it was held that the critical time at which there should be profits was the date of declaration rather than the date of payment.} that distributable profits should exist at the time of the declaration of the dividend but not at the time of its payment.\footnote{\textit{Mecca Developments Ltd v BW Rofe Pty Ltd} (1977) 52 ALJR 89 per Mason J.} In contradistinction, section 254T does not require that there be profits available at the time of declaration of the dividends. Profits must exist only when the dividend is paid. However, when the company has a...
Chapter 5  
5.4. Some Policy Problems (When Must Profits Exist)

constitution and it provides for the declaration of dividends, s 254V (2) requires that the company incurs a debt when the dividend is declared. According to the Explanatory Memorandum to the Corporations Law Review Act, s 254T has the effect that profits must exist at the time fixed for payment of the dividend. The replaceable rule in s 254U (1) provides that the directors may determine that a dividend is payable as well as fixing the amount to be paid at the time and method of payment. A clearly construed view of the process set out in the replaceable rule would mean that because a dividend represents a debt owed by the company to each entitled shareholder, the time at which the debt arises under s 254U is when the time fixed for payment arises. Before that time, s 254V (1) may be evoked so that the decision to pay may be revoked at any time.

It may be argued that the preferred approach should be that profits to fund a dividend should exist at the time of declaration of the dividends. The reason for this view is that the practical effect of s 254V (2) and s 588G (1A) would be that the company is indebted to the shareholders only at the time of the declaration. The dividend is taken to be payable to shareholders on the date it is properly declared even though the date of its payment may be deferred. This view is consistent with Mason J in Industrial Equity Ltd v Blackburn, where it was held that the declaration of a final dividend gives rise to a debt payable by the company to the shareholders immediately or from a date stipulated for payments. Further, directors' liability is also triggered from the time the dividends are declared. Because the company's constitution dictates the mechanism by which dividends are to be declared, the amount of the declared dividend can be considered to be the

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195 Under s 254W (2), as concerned proprietary companies, the directors may pay dividends as they see fit. This would imply that directors recommend that a dividend of a given amount should be declared, leaving the power of declaration with the general meeting of members. This was the position under Table A, Articles of Association.
197 (1977) 137 CLR 567 at 572 per Mason J. Cf. Brookton Co-op Society Ltd v FCT (1981) 147 CLR 441. It is noteworthy that if a declared dividend is expressed to be payable on a stated date, a shareholder cannot seek to recover it as a creditor until the stipulated date for payment has passed: Potel v IRC [1971] 2 All ER 504 at 511 per Brightman J.
198 The common law principles must also be taken into account.
property of the shareholders before it is physically handed over to them and this declaration cannot subsequently be revoked.  

Comparatively, in the US case of *Dodge v Ford Motors*, the Michigan court held that a dividend arises at the time of the declaration of the dividends. The argument that profits exist at the time of declaration is still justifiable even if there is a downturn in the company’s financial position between the date of declaration and the date of payment, and the company finds itself in a position where it could not lawfully discharge its debts to its shareholders. Because s 254T makes the company’s directors liable to be sued by shareholders to recover the debt which arose when the dividend was declared and there were no available profits, in such a situation, the company can borrow the necessary cash to pay the dividends. The Explanatory Memorandum to the Corporations Law Review Act, appears to incorrectly suggest that the decision to pay any dividend (declared) may be revoked under s 254V (1) at any time before it is paid. It is submitted that the courts position in *Industrial Equity*, is the preferred approach.

### 5.5. Consequences and Remedies for Unlawful Dividends

#### 5.5.1. Remedy for Unlawful Dividend Payments (Unauthorized distribution).

The mechanisms for regulating dividend distributions seek to ensure that creditors and shareholders are protected from any unlawful distributions which have the effect of prejudicing their interests. Serious consequences and remedies follow both under the common law and statute, if the law is breached. Under the Corporations Act, when a company pays a dividend which is not out of the profits of the company, it is possible that both s 256B (reduction of capital) and s 254T (unlawful distribution) provisions would be breached because the company would have paid such dividends out of the share capital of

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199 See, *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353, where a company’s constitution usually require dividends to be declared by the company before they become payable and it was unusual for a dividend to be paid without declaration.

200 204 Mich 459 (1919).

201 See, *Mills v Northern Rly of Buenos Ayres Co* (1870) LR 1 Ch App 621; *QBE Insurance Group v ASC* (1999) 32 FCR 270. Section 254T to an extent is consistent with the case law on this issue. Therefore, it is difficult to see if the limitation in s 254T effectively overrides the dicta in the *Marra Development* case that a validly declared dividend may be paid even if there are not profits at the time of payment.

202 Explanatory Memorandum, above n 198 para 11.40.

the company, which is an unlawful return of capital prohibited by law. Accordingly, a recipient of an unlawful dividend paid by a company is liable to return it if the person who knew, or ought to have known that such a dividend was not paid out of profit. Directors also contravene s 588G if they fail to prevent a company incurring a debt when they suspect, or should suspect that a company is insolvent, or would become insolvent as a consequence of incurring the debt. Initially, it might be suggested that the remedies for any unlawful payment of dividends would seem to protect creditors and shareholders. However, these statutory remedies may not be easily attainable because they leave much scope for uncertainty:

- When does a shareholder possess constructive knowledge that a dividend was unlawful? Can gratuitous dispositions in the nature of loans and gifts made by the company also be considered unlawful?

- How does the law recover unlawful dividends from recipients who have already used part or all of the dividends or, who are not easily traceable?

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204 A shareholder who disputes the validity of a declaration of dividend may obtain an injunction to restrain payment (see, Darvell v North Sydney Brick & Tile Co Ltd (1988) 14 ACLR 474. A creditor also has standing to seek an injunction under s 1324 to restrain the company and its directors from paying a dividend that breaches s 254T. Since insolvency is an element of a contravention of s 588G, the companies’ members and creditors may invoke s 1324 (1) (a) to restrain the payment of an unlawful dividend, or where the payment of a dividend would lead to the company’s insolvency. Any unlawful dividend may also be rendered void, see the Maroo Development, above n 70, Industrial Equity, above n 84. However, because transactions in breach of s 256 are not void, these cases may not seem to be relevant.

205 A recipient of an unlawful dividend in this case would refer to either the shareholders or company directors, in their capacity as members. The essential characteristics of a recipient, according to Aegip (Africa) Ltd v Jackson [1990] Ch 265, 290, is that he should have received the property for his own use and benefit. A director who authorizes such unlawful dividends faces either a civil or criminal sanction. Any unauthorized payment exposes directors liable to pay the amount of the dividend to the company under general law doctrine. In addition, directors are liable to compensate the company in relation to dividends whose payments impair the company’s solvency. The payment of a dividend is deemed to constitute the incurring of a debt for purposes of insolvency trading a two years prison sentence or both under s 1311. However, though an unlawful dividend payment may be rendered void and a breach of s 256B, the company is not guilty of an offence under s 256D (2) (b) and the contravention would not affect the validity of the dividend payment. Arguably, although s 256D (2) (b) does not purport to ameliorate the consequences of s 254T (which is a criminal provision), it is unclear why a breach of s 256B should not invalidate the transaction. If creditor protection and the preservation of the company’s share capital are the principal goal of the capital maintenance doctrine, it would have been appropriate that any breach of both ss 254T & 256B should render any such payment void and any payment received, should be returned back to be made good to the company.

206 Corporations Act 2001 (Cth), s 588G (1A) is to effect that a company incurs a debt when it pays a dividend pursuant to its constitution other than a dividend which had been previously declared. The application and effectiveness of s 588G (1A) has been considered very curious because, a payment of a dividend to a shareholder would usually discharge whatever debt might then be owed to the shareholder in relation to the dividend. One arises immediately and is thus regarded as being incurred immediately for purposes of s 588G. (See, Hambrook, above n 197 at 2.6.0325). Directors who authorized an improper payment of dividend could also be in contravention of s 180, which imposes the duty of care and diligence.

207 Cf Aveling Barford Ltd v Perion Ltd [1989] BCLC 626.
Chapter 5  

5.5. Consequences and Remedies

- The law does not expressly say whether an innocent recipient without any constructive knowledge of an unlawful dividend would also be liable to return such a dividend or, whether such a person might be subjected to any civil or criminal sanctions.\(^{208}\)

5.5.2. Liability on members & directors with constructive knowledge

The common law position\(^{209}\) of holding directors personally liable to repay the amount of the unlawful dividend or dividend out of capital is statutorily adopted by the Corporations Act. In addition a recipient of an unlawful dividend paid by a company is liable to return the amount of the dividend if the person knew or ought to have known that it was not paid out of profits of the company.\(^{210}\) In *Segenhoe Ltd v Akin*,\(^{211}\) the company, had gone into liquidation as a result of certain unlawful dividend payments. The liquidator sued the auditors (who were also shareholders of the company) for a recovery of the amount of the loss suffered by the company, due to a negligent advice resulting in payments of dividend which were not supposed to be made. The court held them liable to make good the amount of the dividends paid because the amount of the dividend paid out of capital was the measure of the company's loss. Gilles J outlined the three possible ways by which shareholders may be liable:

- The company had paid money out on the basis of a mistake of fact (i.e., a mistake as to its financial position) which was fundamental to the transaction;
- The company had exceeded its statutory powers by making an illegal distribution and was entitled to seek restitution from those of its members who had received it;
- The recipient shareholders were constructive trustees of the dividend because they paid no consideration for it, and received it pursuant to an unlawful transaction.

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\(^{208}\) Cf the following decisions: *Segenhoe Ltd v Akin* (1990) 29 NSWLR 569; *Moxham v Grant* (1900) 1 QB 88, 91; *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447, 457.


\(^{210}\) While s 254T has absolutely nothing to say on the issue, it seems to apply the common law principle that, any unlawful payment of dividends could be recovered from the recipient if a directors or shareholder who had constructive notice of the affairs of the company and where such a dividend payment was not legitimate. *In Leeds Estate, Building & Investment Co v Sheppard* (1887) 36 Ch D 787, certain payments in the nature of dividend held both the directors and auditors liable for the amount because, they have failed to apply their minds to the true state of the company’s affairs.

\(^{211}\) (1990) 29 NSWLR 569.
Chapter 5  

5.5. Consequences and Remedies

While the above decision may be correct it is unclear if it can be accepted as a strong precedent as to when recipients of unlawful distribution could be held responsible to put the company back into its original position especially, when the company's financial resources have been seriously affected through wrongful payments. Firstly, as indicated above, the liability provision under s 254T leaves much scope for uncertainty. It is less clear if the liability in the above case was based on a breach of what is now s 254T or s 256B? The latter provision does not invalidate the unlawful transaction. The former provision is silent. Secondly, it is not clear whether an innocent recipient is also liable to reimburse the company. The cases are mixed.212 Thirdly, it is also not clear as to when a recipient of an unlawful dividend may have constructive knowledge that the payment of a dividend was not within the parameters of the legislation. Lastly, what steps are taken by the judiciary and legislature to make sure that an unlawful dividend could easily be traceable and recovered?

The above questions have been considered in case law with results more complex and difficult. In Blackburn v Industrial Equity Ltd,213 the board of directors had declared a special distribution payable partly in cash and partly by distribution of fully paid up shares. The High Court held the dividends were an unauthorized payment in breach of the law.214 Three shareholders then applied to the Supreme Court of New South Wales for a declaration that the resolution for the payment was invalid because it breached former s 376(1) of the 1961 Act (now, s 254T) by paying dividends not out of profits. They also sought an order that the directors repay the amount of the dividend.

212 See for example, Segenhoe's case, above n 209 Precision Dippings Ltd v Precision Marketing Ltd [1986] Ch 441 and Moxham v Grant, above n 209.
213 [1979]ACLJ 40, 604. It is a correct proposition of law that where directors have paid dividends out of capital, shareholders who received such payments with knowledge that the payment was unlawful are jointly held with directors to repay recipient shareholders to indemnify them against their liability in respect of the payment. This proposition is supported by Re Alexandra Palace Co (1882) 21 Ch D 149. There, two shareholders were held liable to repay the dividend received by them because they were implicated in the transactions part of which was the payment of the dividend out of capital since they were parties or privy to the transaction. Also, in Moxham v Grant [1900] 1 QB 88, an action was brought by the directors against the shareholders to recover part of the sum which the directors had been required to pay to the liquidator of the company. Smith LJ posited that shareholders who received part of the capital of a company with notice were constructive trustees for the company of money so receive. His Honour emphasized that shareholders had notice that they were receiving part of the capital of the company and that it was not a case of a shareholder receiving money of the company in ignorance that he/she had no right to it.
214 Industrial Equity Ltd v Blackburn (1977) 137 CLR 567.
Chapter 5  5.5. Consequences and Remedies

Needham J held on behalf of the shareholders. An appeal against the decision was dismissed by Hutley and Glen JJ. A second appeal was made to the High Court which was also dismissed. One of the defenses of the directors was that the company had later generated profits sufficient to allow the payment of a dividend in the amount which had been paid, for which the directors relied upon Flitcroft’s case. Needham J rejected the argument saying:

I cannot see any justification in Flitcroft’s case for the proposition that a shareholder cannot bring the directors to book if it can be proved that the company has made profits subsequent to the payment of the dividend which would permit such a dividend to be paid.

Although the above decision may be correct, it is still difficult to visualize a situation in which a knowledgeable shareholder may be imputed with constructive knowledge of the financial situation of a company or that a particular dividend payment was unlawful, especially, if the shareholder had no controlling influence over the affairs of the company or, was even a passive shareholder who only relied on dividends from the company. While directors may easily possess full knowledge of the company’s affairs, the common law remedy against shareholders as constructive trustees of the company’s property has remained debatable.

A similar issue of holding knowledgeable directors and shareholders liable for unlawful dividends can be found under the New Zealand Companies Act 1993, s 56(1) and in the judgment of Tipping J in Hilton International Ltd v Hilton.

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215 Citing Re Exchange Banking Co (Flitcroft’s case) (1882) 21 Ch D 519, his Honour held that directors of a company who are parties to an invalid payment of dividend out of capital are prima facie jointly and severally liable to repay the amount to the company. He contended that, such directors are entitled to an indemnity from shareholders who are parties or privies to the payment of the dividend out of capital (see, Re Alexandra Palace Co (1882) 21 Ch D 149). It was further asserted that if the shareholders received the sums with full knowledge of the facts establishing that the dividend was unlawful, they are constructive trustees of the sums distributed to them like directors who are being in pari delicto with the shareholders.

216 Ibid, 34, 029

217 See for example, Precision Dippings Ltd v Precision Dippings Marketing Ltd [1986] 1 Ch 447; Re Sharpe [1892] 1 Ch 154; Flitcroft’s case, above n 216. It is importantly noteworthy that this remedy of holding directors as trustee has received criticism from some commentators (see, L.S. Sealy, “The Directors as Trustees” [1967] CLJ 83.

218 See Companies Act 1993, ss 56(1) (a-c) & s 56(2) (b-d). Section 56(1) requires an improper dividend distribution to be recovered from shareholder(s) unless: the shareholder received the distribution in good faith and without knowledge of the company’s failure to satisfy the solvency test in s 4(1); or the shareholder has altered his position in reliance on the validity of the distribution, and it would be unfair to require payment in full or at all.

Chapter 5  5.5. Consequences and Remedies

This was a civil proceeding by a company in liquidation in which it sought to set aside a declaration of trust made by the company’s directors and the repayment of a dividend credited to shareholders who were also the directors. The action was brought by the liquidator against a certain Mr. & Mrs. Hilton as sole directors and shareholders, for wrongfully declaring and paying a dividend partly out of the company’s paid-up capital in breach of the law. Tipping J, following *Re Oxford Benefits Building & Investment Society*, found the directors liable to return the amount of the dividend. As concerns recipient shareholders, he reiterated that in many cases of small private companies, the directors and shareholders will be the same people.

There is authority for saying that if a shareholder knows that a dividend has been wrongly declared, he/she is liable to refund it to the company on demand. This decision is consistent with that of the English Court of Appeal in *Towers v African Tug Co.* A more difficult question in reliance on the knowledgeable test arises when the actual knowledge of the impropriety of a dividend cannot be established, but either the shareholders or directors are regarded as having constructive knowledge. In *Westpac Banking Corp v Savin*, Richardson J said:

> The more difficult problem lies in deciding what yardsticks are to be applied in determining whether or not the person charged as constructive trustee had the requisite knowledge. The most recent comprehensive discussion of this difficult question is in the 131-page judgment of Peter Gibson J in *Baden, Delvaux & Lecuit v Societie General Pour Favoriser le Developpement du*

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220 (1886)35 Ch D 502. There, it was held that when an order is made against directors for unauthorized payment of dividends, the sums paid out as dividends must be repaid with interest. The decision in *Hilton* also followed from the statement of Jessel MR in the *Flitcroft case*: “The creditor has no debtor but that immoveable thing the corporation, which has no property except the assets of the business....It follows then that if directors who are quasi trustees for the company improperly pay away the assets to the shareholders, they are liable to replace them. It is no answer to say that the shareholders could not compel them to do so. I am of the opinion that the company could in its corporate capacity compel them to do so, even if there were no winding up” (at 533-539). Contra *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZ LR 242, a similar case to Hilton International which involved a question of unlawful dividend payment. The directors were held not liable to refund the amount of the dividend lost by the company the premise that, they acted honestly. Cooke & Richardson JJ took the view that there was no basis upon which the payment of dividends was likely to cause loss to creditors, and there was no basis in the evidence for a finding that immediately following the restructuring the companies commercial solvency was doubtful (at 249). Sommer J, emphasized that before the directors could be found liable they must be shown to be guilty of something in the nature of a breach of trust. But where they reasonably and honestly believe that the company’s financial position is healthy and creditors will not be jeopardized, they cannot be held liable.

221 [1994] 1 Ch 558 per Vaughan William, Stirling and Cozens-Hardy LJ.
222 This is apparent in the constructive trusteeship cases, such as was discussed by the Court of Appeal in *Wespace Banking Corp v Savin* [1985] 2 NZLR 41.

223 Ibid.
5.5. Consequences and Remedies

Commerce et de l’industrie en France SA. There are five categories or types of knowledge: (1) actual knowledge; (ii) knowledge which is obtainable but for shutting one's eyes to the obvious; (iii) knowledge obtainable but for willfully and recklessly failing to make such inquiries as an honest and reasonable person would make; (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable person; (v) knowledge obtainable from inquiries which an honest and reasonable person would feel obliged to make, being put on inquiry as a result of his or her knowledge of suspicious circumstances. For myself, I would favour the proposition that shareholders who have received a dividend improperly declared are liable to repay it to the company if they either knew or have known, upon any of the above bases, of the circumstances.

The general remedy deduced from ‘knowledgeable recipients’ of improper dividend payments is the fact that they are liable in equity as constructive trustees to repay the money or compensate the company. This remedy carries some force in protecting creditors yet, it remains problematic.

5.5.3. Recovery from innocent (Non knowledgeable) Recipients.

Australian law is not explicit on how creditors may be protected from innocent recipients of unlawful dividends. While guidance may be obtained from English judgments, some commentators are of the view that a dividend paid out of capital, or, paid out of profits but innocently received by shareholders or even nominee directors cannot be recovered except in a winding up. If this view is correct, then it will have serious consequences on creditor protection. While the position of case law is inconsistent, the legal analysis used to recover dividends unlawfully paid to innocent recipients, however, is subject to dispute.

5.5.3.1. Recovery of improper dividends from innocent directors.

In Lucas v Fitzgerald, dividends had been paid out of capital to three directors of the company. The company was subsequently wound-up, and it sought to make the directors liable for the dividends received by them. One of the directors, who had been present at

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224 [1983] BCLC 325
225 [1985] 2 NZLR 41, 52.
227 A simple example is that the position of ‘disguised dividends’ such as loans and gifts to related parties is not clearly spelt out as to whether they would be considered as unlawful distribution. However, subjecting loans to the dividend distribution requirements, would cast a shadow of uncertainty over loans between affiliates. If this is to be taken into account, this may possibly heighten the already clouded and problematic concept of dividends and profits.
228 (1903)20 TLR 16.
the meeting at which dividends was declared, was held liable. The other two directors against whom the claim was made had not been present at the meeting and it was held that there was nothing which they knew or ought to have known to suggest that the dividend had been declared otherwise than properly. Lord Alverston CJ first held that the two directors were not liable then continued:

Then comes the point whether a director who receives money which, as it turns out he ought not to have received, can be compelled to refund upon this point. I am bound by the conclusive authority of *Re Denham & Co* which decides that a director who receives money innocently cannot be compelled to refund it either under s 165 of the Companies Act 1862; which is similar to s 10(1) of Company (Winding-up) Act 1890, or as money had and received, or on any other grounds. Moreover, from the decisions in *Re Denham & Co* and *Flitter's* cases, it would follow that if a director was liable for the money received by himself, he would also be liable to refund money paid to other shareholders. I am also bound by the judgment of Lord Davey in *Dovey v Cory*. Therefore, I think that the action as against (the two directors) is misconceived, and must be dismissed with costs.230

Though the decisions in *Lucas* and *Re Denham* give support to Halsbury, it is difficult to see these judgments as a conclusive authority on the question whether a liquidator can or cannot recover unlawful dividends from innocent directors.231 The only decision, which might stand for that positive proposition, *Lucas v Fitzgerald*,232 is only doubtfully founded on *Re Denham & Co*;233 which itself leaves much confusion in reference to the

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229 (1883) 25 Ch D 752. There, dividends were paid to a sleeping & innocent director of the company who had no knowledge of the financial position of the company. Chitty J described the director as a country gentleman and not a skilled accountant and, cannot be held guilty of negligence or breach of duty such as to be liable to repay the whole amount of the dividend paid out of capital to himself and other shareholders.(at 767).

230 Ibid. 18.

231 *Cf Corporation Act 2001* (Cth), s 588G which purports to give a liquidator powers to recover from innocent recipients. However, in *Towers v African Tug Co* [1904] I Ch 588; a dividend was paid out of capital in circumstances in which (as it was held) the shareholders who approved the payment of the dividend in general meeting had notice thereof. Two of the shareholders brought an action on behalf of themselves and all other shareholders against the company and the directors to compel the directors to repay to the company the amount of the dividends. The other shareholders were later joined as defendants. All the defendants counterclaimed for the repayment by the plaintiffs of part of the dividends received by them. Byrne J held the defendants did not. The appeal was successful. Vaughan William LJ acknowledged that the payment of the dividend was ultra vires but held that an action could not be brought by an individual shareholder to complain thereof "if he himself has in his pocket the time he brings the action some of the proceeds of that very ultra vires act". Sterling LJ took a different approach apparently, considering that the plaintiff shareholders should not be permitted to bring an action on behalf of themselves and the other shareholders, where the company itself was content not to bring an action, but rather to make up its deficiency in capital by successful trading, and where the amounts involved were small. *Cf. Moxham v Grant* [1900] QB 88.

232 (1903) 20 TLR 16.

233 (1883) 25 Ch D 752.
principle upon which the shareholders’ liability might rest. In *Precision Dippings Ltd v Precision Dippings Marketing Ltd*, dividends were unlawfully declared and paid out of capital in breach of s 263 of the *Companies Act 1985* (UK). The liquidator brought many causes of action including recovery of the amount that the company lost from the company’s directors who were also shareholders. Some of them argued that by the time of the payment, they had no knowledge of the financial situation of the company or, that the dividends were unlawful. (In effect, they were claiming to be innocent recipients of the dividends). The court held that all the relevant facts were within the knowledge of the recipients and so, they were liable for the loss suffered by the company. Dillon LJ, giving the judgment of the court, stated that the group of sections now contained in the 1985 Act, constituted a major protection to creditors, and shareholders were not free to waive or dispense with these requirements.

In considering the remedies available in respect of the unlawful distribution, Dillon LJ looked first to s 277(1) which provides that where a distribution is made in contravention of the requirements of the Act relating to distributions, the members to whom the distribution is made are liable to repay it (or its value if it was a distribution in kind). If only part of a distribution is in contravention of the Act, the member’s liability extends only to that part. In either case, a member is only personally liable under the section where he/she knew or has reasonable grounds for believing that the distribution is made in whole or in part, in contravention of the Act. Also, rather than determining whether the directors could be said to have had reasonable grounds for the belief that there has been a contravention of the Act so as to bring the claim within the second limb of s 277(1), Dillon LJ turned to the common law liabilities in respect of unlawful dividends. His Lordship held that the dividend payment was ultra vires, and as a result, the directors were liable to the company as constructive trustees and were obliged to repay the money. In a similar situation, in *Re Cleveland Trust plc* it was held that the

236 *Companies Act 1985*, s 277(2) provides that the statutory liability is without prejudice to any other obligation imposed on a member to repay in unlawful distribution.
237 See, *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246, 298. There, Slade LJ & Wilkinson LJ held that to establish liability as a constructive trustee, the knowledge required is knowledge of the relevant facts and not of the consequences of those facts (i.e., the test is whether the person had knowledge, actual
failure to satisfy evidentiary requirements, namely, the absence of accounts giving a true
and fair view of the company’s financial position as required by s 272 of the 1985 Act
was held to invalidate a distribution. Though the court acknowledged that ignorance of a
particular statutory provision had no effect or relevance on the question of whether or not
a provision has been breached or, of the consequences of any such breach, the fact that
both ss 254T & 277 require the recipient of the unlawful dividend to know, or to have
reasonable grounds for believing that there is a breach of the law may limit the impact of
the statutory liability, though, this may not be the case for purposes of s 588G.

The general idea of subjecting an innocent recipient to the constructive trust ideology
remains far from clear. For liability as a constructive trust to arise, it must be
demonstrated that the directors acted in breach of fiduciary duties and that the recipient
was aware of the factual circumstances amounting to the breach of trust, but in Precision
Dippings, the recipient did not need to be aware of the law. Arguably, payment of an
unlawful dividend is, broadly speaking, regarded as a breach of fiduciary duty by
directors. The precise degree of factual awareness that is necessary to trigger constructive
trust liability is a complex question on which there are conflicting authorities.239 Outside
equity investors in a company who are not involved in management would rarely have
the requisite knowledge of a company’s financial position. The remedy of a constructive
trustee is most likely to work in relation to intra group dividends or to dividends paid to

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239 [1991] BCLC 424. There, the recipient of an unlawful dividend (a parent company), was held liable as a
constructive trustee to repay the dividend to its subsidiary.

for a New Landmark’ in W.R. Cornish, R.O. Nolan, Sullivan & J. Virgo (eds) *Restitution Past, Present and
Future* (1998) 231. The New Zealand judiciary and legislature provide a possible approach for adoption. There, a
distribution made to shareholders at a time when the company did not immediately after the distribution, satisfy
the solvency requirements, and where a dividend payment would result in the company being unable to pay its
debts as they fall due, directors should not declare the dividends at all. Directors who recommend the declaration
and payment of dividend in breach of the law, are personally liable to the company to repay so much of the
distribution as is not to be recovered from shareholders (see, s 56 (2) (b-d)). Shareholders who also received the
distributions are to pay back the amount so received unless (a) the shareholder received the distribution in good
faith and without knowledge of the company’s failure to satisfy the solvency test; (b) the company has altered the
shareholders position in reliance on the validity of the distribution; (c) it would be unfair to require repayment in
full or at all of the distribution (see, s 56(1)(a-c)). This liability position is reflected in the decision of the courts
in, *Hilton International Ltd v Hilton* [1989] 1 NZLR 442. This remedy is reinforced under the Corporations Act
by S 588G which makes directors liable to the company when they authorize payments and distributions that
would render the company insolvent.
individual members who are also closely involved in the management of companies.\footnote{It is significant that in both Precision Dippings and Re Cleveland Trust, the recipient of the unlawful dividend was a parent company.}

5.5.3.2. **Tracing unlawful dividends from innocent shareholders**

In the absence of constructive notice, can an innocent recipient (shareholder) who has received and parted with the improper dividend payment be made liable? The Australian judiciary or legislature has not indicated how shareholders and creditors could be protected from an innocent recipient of dividends. Thus, in *Segenhoe v Akins*,\footnote{This view conflicts with *Re Diplock* [1948] Ch 465.} it was held that an unlawful dividend can never be recovered from a shareholder who was totally unaware of the impropriety.\footnote{See, *Re Diplock* (Ibid); A.S. Burrows & E. McKendrick, *Cases and Materials on the Law of Restitution* (1997) 663. Tracing is defined here as the means by which a person can identify his/her property in the hands of others.} The English approach is confused and conflicting. At one stage the view is consistent with the Australian case law. But, at another stage, the concept of ‘tracing’ is used to hold innocent recipients liable. This view which is favoured by some commentators is that there is the possibility of the company being able to trace the unlawful dividend in the hands of shareholders.\footnote{Ibid.} According to the ‘tracing approach’, it is assumed if a company can successfully trace the property, it can seek to recover the property by a personal action (such as an action for money had and received, if only this can be possible at common law) or an equitable proprietary claim such as an equitable charge—which is also not certain to succeed.\footnote{P.H. Millet, “Tracing the Proceeds of Fraud” (1991) 107 LQR 71, 72.}

This common law solution may be flawed. At common law, unlike its equity counterpart, tracing is neither a cause of action nor a remedy but serves an evidential purpose.\footnote{The traditional tracing is that money can be followed at common law into and out of a bank account, but only if it has not been mixed with other money in the account; where as equity is free from that limitation. This is usually said to be because the rules which govern the appropriation of debits to credits were devised by equity and are} The remedy is an order for account and payment. Tracing at common law enables the defendant to be identified as the recipient of the plaintiff’s money and the measure of his/her liability to be determined by the amount of the plaintiff’s money he/she is shown to have received.\footnote{Ibid.} The real difficulties in the way of a common law tracing claim are quite different.
Chapter 5  5.5. Consequences and Remedies

Firstly, the common law has always been able to follow a physical asset from one recipient to another. Its ability to follow an asset in the same hands into a changed form was established in *Taylor v Plummer* 247. In following money into an asset purchased with it, no distinction is drawn between a chosen in action such as the debt of a bank to its customers and any other asset. 248 But in following an asset from one person to another it needs a physical asset such as a cheque or its proceeds to follow which presents insuperable practical difficulties. Moreover, recipients of dividends according to the decision in *Precision Dippings*, are volunteers rather than bona fide purchasers of value. This reflects the fact that even though they have a commercial expectation to receive dividends as part of the return on their investments, legally shareholders are not entitled to dividends unless they are declared or paid. 249

A second limitation on tracing is that a person cannot trace where his/her property is no longer identifiable although it is sometimes possible to trace funds which are paid into bank accounts. 250 A further anomaly with the remedy of tracing is that it is subject to the defense of a change of position, so that, for example, where an individual shareholder uses a dividend for a luxury trip, it will no longer be possible to trace. 251 It does not follow that an innocent recipient cannot be liable in the absence of notice. If, as is suggested, the liability is receipt-based, it should logically be strict.

unknown to the common law. This is true of the rule in *Re Hallett’s Estate* (1880) 13 Ch D 696, which is not an evidential rule but the corollary of equity’s ability (not shared by the common law) to charge a mixed fund with repayment of trust moneys. It is not true of the rule in *Re Clayton’s case* (1816) 1 Mer 572, which is a common law rule and is merely an evidential presumption applicable in the absence of express appropriation.

247 (1815) 3 M & S 562.
248 *Re Diplock*, above n 214, 519.
249 Should a "volunteer shareholder" who has received an improper dividend not entitle to repay it? Arguably, the traditional view should be applicable here in the sense that, he/she is liable to account as a constructive trustee if the money was received with notice, actual or constructive that the money or property transferred to him was in breach of trust; or if it was received without such notice but later discovered the facts before the dividends was spent or parted with. In either case liability can be imposed as a constructive trustee (see, *Karak Rubber Co Ltd v Burden (No 2)* [1972] WLR 602; *Baden Delvaux and Lecuit v Societe Generale*, etc., 5A [1983] BCLC 325. Where the dividend has been used to pay his debts, the company or liquidator can claim to be subrogated to the rights of the creditors whose debts were discharged with his money: *Trevillian v Exeter* (1854) 15 DeG.M&G 828. Unfortunately, the law has been thrown into confusion in England by the judgment of Sir Robert Megarry V-C in *Re Montagu’s Settlement Trusts* [1987] Ch 264, where he doubted whether constructive notice is sufficient, and expressed his own view that dishonesty or want of probity is required. In this writer’s view, this is profoundly mistaken. While it would be unduly harsh to deny defence to the unwitting trustee who acted both honestly and reasonably in parting with the trust property, there is no warrant for introducing a requirement of dishonesty in order to found liability. Liability should be receipt-based, not fault based. (Refer generally to the discussions in; *Austine, Equity in Equity* (1985) 196, 228).
5.5. Consequences and Remedies

Generally, in Anglo-Australian dividend law, the common law remedies of holding knowledgeable and innocent recipients of unlawful dividends to repay back to the company the amount of the money so paid out and, holding them as constructive trustees are very unclear. It is suggested that there is a pressing need for a rational, just and a unified comprehensive restitution remedy with clear rules which prescribe the circumstances in which an improper dividend can be recovered and which identify the persons who can be made liable to repay it. That unified and comprehensive remedy is capable of being developed by recourse to traditional equitable principles and terminology. The liability of the recipient should be receipt-based and strict, and irrelevant of whether he had constructive knowledge. The argument canvassed here can readily be translated into the currently more fashionable restitutionary language of unjust enrichment.\textsuperscript{252}

Although there can be no correct classification of the various different situations that can arise, let alone on the requirements for recovery in each, the duality of our common law and equitable systems, with their differing language and possibly differing rules for dealing with similar situations, adds to the complication. It is the writer’s thesis that in all but the simplest cases recourse to the common law should be abandoned, that attempts to rationalize and develop the common law rules are unlikely to adequately succeed, but that attempts should be made instead to develop a unified restitutionary remedy based on equitable principles.\textsuperscript{253} It is necessary to consider two distinct situations: Where the recipient, with constructive knowledge or innocently receives an improper dividend and still has it; and secondly, where the company’s money has been received by the recipients and they have spent it or parted with it. The first situation may be straightforward. It involves a simple proprietary claim. It calls for strict liability. All the creditors or liquidator needs are adequately protected. The second situation is essentially the same, save that a proprietary remedy is obviously no longer available. It calls on the same strict

\textsuperscript{252} This approach is similar to those of other commentators; see, J. Ulph, “Equitable Proprietary Rights in Insolvency: The Ebbing Tide” [1996] JBL 482, 504; P.J. Millet, above n 217, 85

\textsuperscript{253} This approach has been used in similar situations of tracing the proceeds of fraud. (See, P.H. Millet, “Tracing the Proceeds of Fraud” (1991) 107 LQR 71, 71.
liability, but this should now be subject to a defence based on change of position. An alternative view is that in such situations, directors who authorize the declaration and payment of the dividend in breach of s 588G (1), would be liable under s 588G (1A) and they can then seek an indemnity from recipient shareholders.

5.6. An Alternative Approach to Regulating Dividend Distribution

5.6.1. Solvency Requirement: A New Test for determining the Legality of a dividend distribution

In Anglo-Australian law, there are judicial and legislative imposed requirements for company directors to only declare and pay dividends out of the profits of the company. The idea of restricting dividends to profit is in accordance with the capital maintenance doctrine. The Charters of some of the early companies limited dividends to profits in order to ensure the maintenance of sufficient capital to carry on the business. This was thought to help protect present and future members from fraudulent representations of prosperity. This rationale was relevant during the period of the Trevor rule where there was little publicity. It has diminished in value in recent times where creditors and shareholders are exposed to enhanced disclosure to transactions that may decrease the value of the company’s assets.

The contemporary approach to creditor and shareholder protection has significantly relaxed the capital maintenance doctrine in most areas of corporate share transactions and distributions such as, buy-backs (s 257A), reduction of capital (s 256B) and financial assistance (s 260A). Though the Corporations Act has shifted significantly from the capital maintenance doctrine, s 254T adamantly remains rooted to that doctrine with the assumption that if dividends are limited to profits, it will protect creditors by preserving the cushion of their entitlements or, (a minimum value of assets to secure payment of creditors claims). That assumption, if correct, remains questionable and far from

\footnote{The common law has been defective in this situation because it lacks any proper change of position defence. (See, Australia and New Zealand Banking Group Ltd v Westpac Banking Corp (1988)164 CLR 662. See also, G.J.Baker Ltd v Medway Building & Supplies Ltd (1958) 1W L.R 1216 (a situation where a recipient had parted with the dividends received).}

\footnote{Corporations Act 2001 (Cth), s 254T is in harmony with the already established common law principle in Mackie v Clough (1891) 17 V.L.R 493, 495. See also, Companies Act 1985 (UK), s 263 and common law decisions such as, Lee, above n 8; Verner, above n 11; & Ammonia Soda, above n 18.}
adequate, taking into consideration that ‘profit statutes’ do not adequately define the term profit nor, do they provide any uniform standard for measuring it.\footnote{56}

Generally, the notion of restricting dividend payments to profits has not only caused enormous legal uncertainty, but may lead to the conclusion that statutes embodying rules on distribution from the concepts of ‘dividends and profits’ remain very doubtful especially, if one were to take into consideration the manner in which dividends are distributed in Australia.\footnote{57} The only possible suggestion would be for current s 254T provisions on dividends to be jettisoned in favour of a more accommodating approach of solvency,\footnote{58} as found in other provisions of the Corporations Act, but more preferably, the dual solvency approach found in comparable legislation in Canada and New Zealand,\footnote{59} reinforced by International Accounting Standards.\footnote{60}

\footnote{56} ‘Profit statutes’ for purposes of this study, refer to those jurisdictions which restrict dividends declaration and payment to the profits of the company (see, for example, Corporations Act 2001, (Cth) s 254T (Aust), Companies Act 1985, s 263 (UK) and the Revised Model Corporations Act ( "RMCA") of many US states). The limited meaning provided in decisions such as Re Spanish Prospecting and s 263 of the English Acts, remain unsatisfactory. The terms ‘profits’ and ‘dividends’ have been so broadly explained so much that they even cover a wide range of transactions whereby assets are directly or indirectly transferred to shareholders for less than the market value (see for example, Re Hall Garage (1964) Ltd [1982] 3 All ER 1016; Aveling Barford Ltd v Perion Ltd (1989) 5 BCC 677). Neither accountants, economists nor tax law have comprehensively provided any legal guidance for purposes of the Corporations Law. Also, the machinery of currently regulating dividend is exceedingly complicated. It involves a system of rules difficult to formulate and enforce.

\footnote{57} See for example, the decision of the New South Wales Court of Appeal in Marca Developments Ltd v BW Rope Pty Ltd [1977] 2 NSWLR 616. See also, Australasia Oil Exploration Ltd v Lachberg (1958) 101 CLR 119, 133 where no provision is made for depreciation before dividends could be declared and paid. (With these different methods applied in Australia, it is not possible that the policy objective and rationale of the capital maintenance doctrine– which seeks to protect creditors can be sufficiently attained).

\footnote{58} This view is consistent with other areas of the Corporations Act which though, do not expressly mention solvency, by implication, attempt to regulate share capital transactions and other distributions such as buy-backs (s 257), reduction of capital (s 256) and financial assistance (s 260) by ‘solvency’ and insolvent trading laws. This is also the view recommended by the Australian Accounting Research Foundation ("AARF"), “Payment of Dividends under the Corporations Act 2001” (2003) Legislative Review Board Discussion Paper at: <http://www.aarf.asn.au> at 2003; The Corporations Committee of the Law Council of Australia (Corporations Committee), “Proposal for Reform of Section 245T of the Corporations Act” (September, 2004) at http://www.lawcouncil.asn.au. Arguably, the policy limiting dividends to profits remain far from clear as a cushion for creditor protection. Therefore, if buy-back can be regulated through a solvency test, there is no reason why the law on dividend distribution should not follow suit.

\footnote{59} See generally, Canadian Business Corporations Act 1990, s 41 & 42, and the New Zealand Companies Act 1993, ss 4 & 52 (also, at http://frangi.knowledgesite.co.nz/abca/abcaŷ/1993/sy/165944.html). The New Zealand Law Commission which was charged with the duty of reviewing the country’s dividends law found that the previous law in New Zealand where dividends could only be declared out of profits was unsatisfactory. The recommendation resulted in the repeal of the law which was based on dividends and profits to a solvency based approach as the optimum criteria for regulating the distribution of dividends. The reasons cited by this Law Commission for shifting to the solvency test included that, the concepts of profit and capital were unclear; the existence of an artificial distinction being drawn between fixed and circulating capital; the problem of losses not having to be made up for prior years before dividends could be paid and, the questionable nature of unrealized and realized gains on fixed assets appearing to be available for distribution (see, NZ Law Commission, Company Law (1987) A Discussion Paper & Preliminary Paper No 5 at 23). Although this study suggest Australia should repeal
5.6 Alternative Regulation

In these jurisdictions, a dual solvency tests is the more preferable method used in the regulation of distributions and payments to shareholders.\(^{261}\) Under the solvency approach, dividends cannot be declared or paid if the company will not be able to meet any of the two limbs of solvency tests. The first limb of the solvency approach which is consistent with other provisions of the Corporations Act, requires the directors before making any payments or distribution, to consider whether the company is able to pay its debts as and when they become due and payable (the cash flow solvency).\(^{262}\) This is reinforced by s 588G (1A) which indicates when a debt is incurred. For this purpose, a debt would be incurred if after the declaration and payment of the dividend, the company would be insolvent as a result of the dividend distribution. The cash flow test would therefore require directors to make sure that at the time of declaration of the dividend there were reasonable grounds for suspecting that the company was not insolvent or would not become insolvent as a result of the payment of dividend.\(^ {263}\)

The second limb of solvency test which draws support from New Zealand\(^ {264}\) and Canada\(^ {265}\) is based on the state of the company’s balance sheet. This balance sheet

its current ss 245T-U in favour of either the New Zealand or Canadian dual insolvency approaches, however, commentators who also support this approach, do not suggest that the second prone of either the Canadian or New Zealand insolvency test be supported for introduction in Australia because they are considered to be capital maintenance measures which Australia’s reform process has appropriately moved away from. Moreover, such nature of the balance sheet tests would introduce a different form of the profits and dividend deficiencies and would require the reversal of the reform that has exempted small companies from producing a balance sheet. The balance sheet solvency is discounted by commentators because they are thought to be based on historical cost values rather than current values for some assets. (See, “AARF,” above n 259 at 18).

Adoption of the International Accounting Standards (IAS), may have differing impacts on the reported profits of different corporations, based on their operations and financial profiles. The IAS requires that goodwill and other intangibles be valued and written down (if necessary) in a corporation’s statement of financial performance on an annual basis (i.e., both assets, both tangible and intangible, will be valued and thereupon carried in the accounts) in ways that are different to the approach that is taken today by most corporations in Australia and different the common law solvency approach. Also, there are certain items of expenditure which, up to date, have been capitalized but which, under IAS, will be expensed. (See, generally, Corporations Committee, above n 259).

This is more suitable since a company may be insolvent say, in a balance sheet sense but capable to protect its creditors or shareholders because it is adequately solvent in its liquidity or cash flow sense. (The converse may be true).

Each of the changes in recent years to our Corporations Act share capital rules was premised on this concept of solvency. (See for example, s 257J relating to buy-back). This is also reflected in Peter Buchanan Ltd v McVey [1955] AC 516; QBE Insurance, above n 99. In contrast, the policy underlying the Act’s dividend distribution provision is the capital maintenance concept. By requiring that dividends can only be paid out of profits, the legislature is concerned to ensure that directors do not return the company’s capital to its shareholders as this could be to the detriment of creditors.

Section 588G(1) Directors may evoke defences under s 588H (2) & (5) which requires that at the time when the debt was incurred, he/she had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent.

In New Zealand for example, the only constraint the Act places on distributions to shareholders is a dual statutory solvency tests to be met immediately after the distribution. According to s 4 (1), a company satisfies the solvency
solvency requires, the company's net assets to be equal to or greater than its total net liabilities.\textsuperscript{266} Reliance on the solvency requirement is premised on the fact that the primary financial considerations that must go into the determination of dividends are its current and projected earnings, present liquidity, anticipated cash requirements and even the long term capital requirements of the company. Once these factors have been determined by a company's board of directors, there is no valid reason why that decision test if (a) the company is able to pay its debts as they become due in the normal course of business (the liquidity test), and (b) the value of the company's assets is greater than the value of its liabilities including contingent liabilities (the balance sheet test). In determining whether the value of the company's assets is greater than the value of its liabilities, directors must have regard to the most recent financial statements of the company with the requirements of the financial Reporting Act 1993 and, have regards to other circumstances that the directors know or ought to know affect or may affect the value of the company's assets and the value of the company's liabilities: s 52. (See a detailed discussion by, M. Ross, "Major Reform" (1993) 72 Accountants J 174; (New Zealand Society of Accountants); P. D. McKenzie, ‘Corporate Law Reform: The New Zealand Experience’ (1994) 4 ACCL 129, 134).

Recent changes to the CBCA have emphasized solvency, rather than the profit requirement. Section 42 of the CBCA provides: "A corporation shall not declare or pay a dividend if there are reasonable grounds for believing that the corporation is, or would after the payment be unable to pay its liabilities as they become due; or the realizable value of the corporations assets would thereby be less than the aggregate of its liabilities and stated capital of all classes".\textsuperscript{265}

\textit{Company's Act 1993 (NZ)}, s 4 (i) (b). This second limb of the solvency test is not adopted by the Corporations Act. This is the dual approach used in jurisdictions like the US, Canada, New Zealand and the UK in regulating other aspects of financial transactions of a company. Although the New Zealand and Canadian approaches for regulating dividend distribution through a dual solvency requirement are more accommodating than jurisdictions adopting the profit principles, it is not suggested that Australia adopts the second limb of insolvency applied in these jurisdictions because, they leave much difficulties of implementation. A possible alternative to the second limb of insolvency suggested to be adopted in Australia, would be those of the Revised Model Business Corporations Act, s 6.40, and the California Corporations Code, s 500 (b) which provide clear guidelines for computing the amount permitted to be distributed and they also attempt to prohibit distribution before the onset of either liquidity or balance sheet insolvency. These two statutes make substantial revision of their balance sheet solvency tests, allowing financial distributions whenever the corporation's net assets exceed zero. Section 6.40 (c)(2) of the RMBCA for example provides:

"No distribution may be made if, after giving it effect... the corporations total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution". Similarly, s 500 (b) (1) (2) of the California Corporations Code 1996 provides that a distribution may be made if immediately after giving effect thereto: the sum of the corporation's net tangible assets is at least equal to one and one-quarter its liabilities not including deferred taxes, deferred income, or other deferred creditors, and (2) the current assets would be at least equal to the firm's current liabilities. If the average earnings of the corporation before taxes and interest expense are less than the average interest expense for the preceding two years, current assets must equal one and one quarter times current liabilities. (According to the California Code, a corporation must meet two balance sheet tests in order to make distributions. The first part of the balance sheet test is based on the total ratio, exclusive of certain intangibles and deferred items, after the proposed distribution, total assets must equal one and one quarter times total liabilities.

should be limited by the amount of a surplus account or profits of the company.\textsuperscript{267} The balance sheet solvency requirement would require that where a company’s assets exceed its liabilities, the excess must represent profits to the extent that it does not represent share capital.\textsuperscript{268} Though s 254T does not specifically refer to the determination of profits from the solvency test perspective, but relies on the Marra Development approach,\textsuperscript{269} it is the writer’s suggestion that to remove the uncertainty surrounding the concept of profits for dividend purposes, the New Zealand and Canadian approaches\textsuperscript{270} provide a strong case for the enactment of clarifying legislation in Australia.\textsuperscript{271} The suggested solvency approach is apparently necessary because the approval and payment of a dividend needs to have regard to more than just whether the company has made a profit—the ability to actually fund the payment and remain solvent are critical because of the insolvent trading provisions of the Act.\textsuperscript{272}


\textsuperscript{268} This approach is supported by authorities such as, Exon v Deputy Federal Commissioner of Taxation (SA) (1936) 55 CLR 80, 101. See also Income Tax Assessment Act 1936 ("ITAA" 1939) s 44(1) which states that when applied to a company that distributes property whose value is greater than the amount debited to the share capital account, the excess (which is divided) will be paid out of profits for the purposes of s 44(1) provided that immediately after the distribution, the market value of the assets of the company exceeds the total amount of its liabilities and share capital.

\textsuperscript{269} The case law development of dividends and profits which Australian Corporations law still applies to a large extent, were developed between the late 19\textsuperscript{th} and early 20\textsuperscript{th} Century. Most of those principles are not necessarily congruent with modern accounting practices. Thus, they ought not to be reined in rules for good commercial conduct but as broad legal limits on the operation of commercial discretion. (Refer to R. Tomasic et al., above n 197 at 456). Furthermore, the cases defining or explaining the meaning of profits, frequently reformulate the basic principles in terms of a proscription on payment of dividends out of capital. This is consistent with the view of Mason J in Industrial Equity: above n 84 at 29.659 where his Honour said:

The principle which was certainly designed to protect creditors and, I think, shareholders ... inhibits the payment by way of dividends out of a company's capital...

Though s 254T does not relate to 'capital', redirecting the inquiry towards the term 'capital' other than profits provides no greater clarity due to the fact that there are different judicial explanations for capital (See, Chapter 1 of this study).

\textsuperscript{270} See, Canadian Business Corporations Act (CBCA) (1990), s 42, and New Zealand Company’s Act 1993, s 4(1) (a). Both of these jurisdictions while applying internationally recognizable accounting standards for determining distributable profits, they rely more on the solvency test.

\textsuperscript{271} For some analytical evaluation of the strength and weaknesses of the dual solvency approach, see, Chapter Eight of this study. For some discussion of the solvency requirements, also, see, Y. Ben-Dror, “Corporate Distributions and Creditor Protection” (1983) 16 U Cal Davis LJ 374, 380. J. Jennings & R. Baxbaum, Corporations 5th ed, (1980) at 922.

\textsuperscript{272} See, Corporations Act 2001, s 588G. Section 254T requires that a company can only make dividends out of profits of the company. There is however no requirement that a company must make a profit in a given period before being able to authorize and pay a dividends so long as the dividend is paid out of the profits which may have subsequent profits have yet to extinguish accumulated losses.
The solvency of a company was required at common law and under s 588G to be so important that companies are required to provide a solvency declaration, though not in respect of the dividend process. The difference between the dual concepts of solvency can be very great. Solvency in the liquidity sense is concerned with cash flow; a debtor may be able to cope with its bills as they roll in months even though the market value of all its assets is only a fraction of the aggregate of his liabilities maturing over time in the future. The emphasis of the balance sheet sense of solvency is upon liquidation; a debtor might not be sufficiently liquid to meet his current obligations but still hold illiquid resources having a value far in excess of the total of his obligations.

Another reason why the current law on dividends needs to be changed is the number of difficulties with the current provisions of the Act relating to the payment of dividends. They are the incompatibility of current dividend provisions with the policy underlying recent changes to the law; and the lack of a definition of the term ‘profits’ in the Act and the associated difficulties with defining what is permissible and what is not permissible for the purpose of distribution. To ensure consistency with the rest of the Corporations Act, dividend distributions too should explicitly use a solvency test. The writer suggests that a better alternative for determining the amount available for distribution as a dividend is to adopt one part of the solvency test which is consistent with Australia’s past corporate law simplification in terms of share-buy-backs, capital reduction and no par value shares. This view is consistent with recent trends in overseas jurisdictions; and it would reinforce directors’ responsibilities in terms of a company’s solvency. The proposal of a solvency test generally is the better view because, it does not rely on whether there are profits for distribution. It considers whether there are sufficient funds for the payment of debts as and when they become due but, also the amount of debt which is expected to be incurred is also relevant because the cash requirement that servicing the debt entails must be determined.

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273 Companies, as part of their annual return to ASIC or, if applicable, as part of the lodgment of their financial report, complete a solvency declaration.
274 See Y. Ben-Dror, above n 272 at 380.
275 Refer also, to the Australian Accounting Research Foundation, above n 152.
276 For a comprehensive and detail analysis solvency requirements as an optimum mechanism for creditor protection, see, the preceding chapter seven below, where this mechanism has been reserved for purposes of the various share capital transactions.
Therefore, amending s 254T with a dual solvency test would not compromise protection of creditors. The dual insolvency approach reflects reality of the corporate world and, it modernizes and simplifies the law by eliminating several obsolete concepts upon which the dividend law is based. A major concern of corporate law is the specification of assets available for distribution to shareholders. The dual insolvency test is used recently by most contemporary statutes. It is proposed that in repealing s 254T in favour of a solvency requirement, it should be used in conjunction with the s 588G insolvent trading provisions to provide additional protection to creditors.

5.7. Conclusion

The current provisions in Anglo-Australian dividend law which regulate distribution of dividends out of the profits of the company remains out of touch with changes to the law that included the reform of share capital rules (such as the introduction of nor par value shares, relaxation of the capital maintenance doctrine on buy-back and reduction of share capital, the greater emphasis on solvency requirements and International Accounting Standards. In light of these changes, it is argued that the current s 254T relating to the payment of dividends may be totally outdated. Giving the increasing importance of dividend as a financial policy and the recent trends in overseas jurisdictions, it is an anomaly that the rules in Australia with respect of dividends and profits remain antiquated.

The study suggests that s 254T be given a renewed consideration with a view of repealing the provisions subjecting dividends to profits in favour of the solvency approach used by the Corporations Act in other areas of share capital,277 but more specifically to adopt a dual solvency approach used in comparable jurisdictions like New Zealand, Delaware and California. There are various possible alternatives for dividends and profits statutes. This might be possible to discard the present notion or terminology of profits and substitute it with distribution which will be based on a provision that withdrawals must not be made unless after each distribution the dual insolvency requirements in their

277 Cf Hilton International Ltd v Hilton [1989] 1 NZLR 442. There, it was incorporated under the common law that the interests of creditors would be better served if dividends were payable as long as the corporation remained solvent. However, the current proposal of a dual solvency and international accounting standards go far in reforming s 254T that existing profits and solvency formulation.
composite senses are met.\textsuperscript{278} The view taken here is consistent to an extent with that of the Australian Legislative Review Board of the Australian Accounting Research Foundation, which also finds difficulties with the current provisions relating to dividends.\textsuperscript{279} Arguing in similar line with this Review body, there are a number of difficulties with s 254T which relate to the lack of a definition of the term ‘profits’ and associated difficulties with defining what is permissible and what is not permissible for the purposes of dividend distribution.\textsuperscript{280} There is also, the incompatibility of the current dividend provisions with the policy underlying the \textit{Company Law Review Act, 1998} where most transactions affecting share capital are subject to the insolvent trading provisions and indirectly related to solvency. A regime of certainty through a solvency requirement would be more preferred over that which is based on convoluted common law principles. The current system governing distribution in Canada and New Zealand to solvency may be a model but this approach can be reinforced by s 588G insolvent trading which imposes liability on directors for failing to prevent distribution which would render the company insolvent after the distribution.\textsuperscript{281} It is therefore suggested that it is time ‘profit based statutes’, consider reforming their laws by adopting the proposals outlined above. Such a reform would not only remove the technical difficulties involved in defining and determining profits and dividends, but would simplify the law making it more accommodating and consistent with other areas of the Corporations Act relating to share capital, with a view of providing greater protection to creditors and shareholders.

\textsuperscript{278} This is similar to the "\textit{RMBCA}" 1990, s 6 which is to effect that distributions can only be made unless the fair present value of the assets would be at least equal to, say, one and one fourth times the debts and liabilities of the corporation. This provision provides a minimum margin of safety of 25% over debts and liabilities.

\textsuperscript{279} "\textit{AARF}", above n 85 at 12.

\textsuperscript{280} The common law rule, as is applicable in Australia, with respect of the payments of dividends in comparable terms, remains deficient in many ways. The rules fail to adequately provide safeguards against conflicts of interests and the possibility of minority shareholders in private companies being exposed to abuse by the majority especially through the extraction of the assets of the company by the directors through the payments of excessive remuneration. The problem of creditor and shareholder protection cannot be resolved satisfactorily, unless there is an underlying unifying idea of directors and shareholder liability for unlawful dividends.

\textsuperscript{281} To strengthened the protection afforded by the solvency requirements and insolvent trading provisions, it is not also unusual for minority shareholders to invoke the s 232 oppression remedy provisions where they feel any distribution has threatened their interest in favour of the majority shareholders or controlling shareholders (see \textit{Miles v Sydney Meat Preserving Co Ltd} (1912) 12 SR (NSW) 98, 103 where, a minority shareholder complained of failure to pay dividends. The claim was also that the directors backed by the majority, instead of carrying on the business of the company in a profitable way, had invariably paid excessive prices for stock purchased for the company, including those who formed the majority of shareholders). See also, \textit{Re City Meat Co Pty Ltd} (1983) 8 ACLR 673, wherein, a winding-up order was made in respect of a proprietary company on the ground now in s 461(1) (e) and s 246AA. The court found that a substantial shareholder-director automatically influenced the conduct of the company so that the hord restricted payment of dividends, while he was able to draw salary, fees and service payments.
CHAPTER SIX
A MINIMUM CAPITALISATION REQUIREMENT

6.1. Introduction

Given the importance which corporation law attaches to the maintenance of a company's share capital as a creditor protection device originally, limited liability companies were required to have a certain minimum amount of paid-up capital as a condition precedent to incorporation.1 The basic rationale was for the minimum capital to represent a 'capital adequacy requirement'2 which, determined the liability of shareholders and was assumed to protect creditors and the public from the consequences of limited liability.3 This requirement which is currently applied only in England and Europe but not Australia and a lot of other jurisdictions is part of the European Union inheritance from the common law rule that is taken from the 19th Century English model.4

The financial and organisational set-up of businesses is an evolving process which has however necessitated contemporary modern legislation introducing reform relaxing most of the common law capital maintenance rules and abandoning the minimum capitalisation requirement.5 Though the minimum capitalization requirement is deeply rooted in the European Union Member States who still hold strong to the par value regime and on

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1 See, for example, s 1 of the Limited Liability Act 1855 (UK). The capital maintenance doctrine requires that the paid up share capital of a limited company forms a permanent 'fund' available to the creditors of the company to meet their legitimate claims against the company. The doctrine therefore assumes that such share capital is not to be dissipated by the company, (it can be lost in the ordinary course of the company's business), but must not be return to the shareholders, whether, in the form of dividends or otherwise: Trevor v Whitworth (1887) 12 App Cas 409 ('Trevor case'). Most importantly for present purposes, the imperative to preserve capital (in the sense of ensuring that the company had actually received the amount which its issued shares represented and had not returned it to shareholders) was one of the key features leading to the imposition of the minimum capitalization requirement.

2 The 'assumption' here is derived from s 142 of the English Companies Act 1985 and, from the 'recapitalised' and 're-organized' rules adopted by most European Member statutes. For a better understanding of the analogy to a 'capital adequacy' see, section 6.3.4 (below) and the discussion that follows.

3 See, Hansard (1854) Vol CXXXIV 764, 798-800.


5 This requirement was earlier abandoned in 1856 but resurfaced for European Union Member States in 1980.
'capital', there is a general lack of consensus in other jurisdictions.\(^6\) The reasons are due to the fact that the concept of share capital plays a small role in these jurisdictions who have long abandoned the concept of par value and share capital in favour of a no par value regime and a solvency requirement. In this chapter, it will be argued that the capital maintenance doctrine is not a capital adequacy requirement and creditors do not look to the minimum capital for their protection. It is further argued that the European Union minimum capitalisation requirement provides an illusory protection to creditors, and is not justifiable on efficiency grounds.\(^7\) The protection it affords creditors remain a mirage. Finally, the objective would be to construct an alternative regime for the European Union in the form of a statutory guarantee fund.\(^8\)

The suggested reform must be capable of overcoming the weaknesses of the present regime and yet, retain its original rationale, (i.e., protecting creditors but not necessarily maintaining capital). Accordingly, the proposed guarantee fund would be a salve for both limited liability and capital maintenance in the sense that it will afford greater protection to creditors who were unable to contract around limited liability.\(^9\) Moreover, the proposed new regime must be implemented and maintained at a cost acceptable to all corporators. The study suggests an alternative to the minimum capital requirement which will require the State to impose a statutory guarantee fund. The first section (6.2.) provides a legislative background to the minimum capitalization regime. The second sets out the role and usefulness of the minimum capitalisation requirement (i.e., arguments in support of the requirement). Thirdly, the thesis seeks to critically evaluate the loopholes of such a regime. Finally, the chapter discusses and evaluates the proposed alternative regime to the minimum capitalisation requirement.

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\(^6\) These other jurisdictions include Australia, Canada, New Zealand and South Africa.

\(^7\) For 'efficiency' argument, see, E. Ferran, "Legal Capital Rules Under the Pressure of the Securities Markets: The Case for Reform" [2000] as illustrated by the UK Equity Markets, (Unpublished manuscript on file with author).

\(^8\) The purpose of the proposed reform is to suggest the European Union jettison its minimum capitalization requirement in favour of a guarantee fund. The guarantee fund will also reinforce but not lead to an abandonment or repeal of the capital maintenance doctrine.

\(^9\) While the study will aim at providing a stronger mechanism for the protection of creditors from limited liability and facilitating the capital maintenance doctrine, it will not involve into any discussion and explication on the concept of limited liability. That area is exhaustive much documented upon. See, generally, H.B. Hansmann and R.A. Kraakman, "Towards Unlimited Shareholders Liability for Corporate Torts" (1991) 100 Yale LJ 1879; J. Freedman, "Small Business and the Corporation Form: Burden or Privilege?" (1994) 57 Modern LR 556; Whincup, "Inadequate Incorporation-The Abuse of Privilege" (1981) 1 Co Law 158, 159.
6.2. Legislative History (United Kingdom).

The absence of a limitation of liability in the 1844 Joint Stock Companies and Regulation Act, meant that it did not limit the distribution of company assets to shareholders. This absence, led to the enactment of the Limited Liability Act of 1855.\(^{10}\) The Act, limited the liability of a shareholder upon execution against them (in default of the company) to the portion of the issue price of their shares not paid up.\(^{11}\)

This also meant that, member's liability only became relevant if the company went into liquidation and its debts could not be fully discharged out of its assets. This privilege of shielding the shareholders from personal liability\(^{12}\) also gave an independent legal status to companies to be liable to the creditors for their own debts. Consequently, as a result of the combination of limited liability and the separate legal entity concept, investors of capital could use the corporate body as protection against financial risk.\(^{13}\)

In order to enjoy the privileges of limited liability, and to insulate shareholders from personal liability, payment of a certain minimum amount of capital into the corporation as a condition precedent to commencing business was required by section 1 of the 1855 Act. Section 1 required companies to provide a minimum capital of £20,000 and a minimum nominal value of £25 for each share. At least three-fourths of the nominal capital had to be subscribed (i.e., £15,000) and at least one-fifth to be paid-up on each share prior to complete registration of the company (i.e., at least £5 per issued share). When the Act was finally enacted, s 1 required at least 25 members with each holding at

\(^{10}\) (18 & 19 Vict c 133) enacted on the 14\(^{th}\) of August 1855.

\(^{11}\) Ibid, s 8.

\(^{12}\) Also known as the 'veil of incorporation' where the dominant authority was an 1897 House of Lords decision in *Salomon v Salomon* [1897] AC 22. There, a 'one-man corporation' was able to avoid personal liability for contractual debts of a business previously converted from an unincorporated (unlimited liability) sole trader to an incorporated limited liability. (It is to be noteworthy that the development of the principle enunciated in the *Salomon* decision became known as the 'separate legal entity concept'). Limited liability, which is now accepted in theory and in practice, is ingrained in the economic and legal systems of most common law and Civil law jurisdictions. (Australian Corporations Law was also built on the same foundation). For an early U.S case analogous to *Salomon*, see *Dartmouth v Woodward* (4 Wheat), 17 US 518, 636 (1819).

\(^{13}\) Those who give credit to a corporation bear the risks of its insolvency in the absence of any contract or agreement. If a company incurs debts which cannot be paid and it became insolvent, it is the creditors who bear the loss particularly if the company is limited by shares or guaranteed. The creditors can only sue the company and not the members as had previously been the case with some of the old statutes like the *Joint Stock Companies Registration & Regulation Act 1844* (7 & 8 Vic c 110), unless, the corporate veil was lifted or ignored. This combination served to free entrepreneurs from undue restrictions on business endeavors.
least one share of a nominal value of at least £10-making an effective statutory minimum issued share capital requirement of £250 with at least ¼ of this amount to be paid—up on commencing business. This minimum paid up capital (generally known as the minimum capital requirement) was a sum stipulated by law, whereby, companies on incorporation were required to pay in an initial amount of their nominal and paid-up capital as an initial guarantee before they could be ‘officially’ authorised to carry on with business.\footnote{See, Hansard (1854) Vol CXXXIV 798-800; Limited Liability Bill, 1855. Though the common law rule prohibiting limited companies from reducing their share capital or from acquiring their own shares as formulated in the case of Trevor case (1887) 12 App Cas 415; was for many years the main principle of the maintenance of share capital in Anglo-Australian jurisdictions, the requirement for a minimum share capital was hardly a realistic view in Australian corporate finance law.} The legislative policy\footnote{The policy objectives for the introduction of the statutory minimum share capital could be summarised thus: (a) To act as a Trust fund and security on which creditors could rely for payment of their claims on the verge of insolvency. (b) To insulate shareholders from personal liability and for them to enjoy the privileges of limited liability; (c) to protect public creditors—such as tax authorities and social security bodies who cannot protect themselves by bargaining for securities, and so, need to be protected by law reinforcing the financial stability of the companies; (d) to protect private creditors by reducing the risk of fraudulent bankruptcy due to the insolvency of companies whose initial capital was inadequate to protect creditors. (Refer generally to Hansard (2nd Series) Vol 139, cols 1389, 1390). (Despite the above policy reasons for the introduction of the minimum capitalization requirement, it can be argued most of these policy objectives were difficult to obtain. For example, ‘a’ above, is not compelling since the company can use the capital for the purposes of the business and lost that capital exposing creditors to a higher risk of their claims not being satisfied if the capital was lost.} for its introduction was intended to protect creditors and also to enhance confidence in the financial safety of the market. It was also intended to prevent frivolous incorporation.\footnote{See for example, Hansard (1854) Vol CXXXIV 764,798-800. As noted in this (ed), the protection of limited liability to shareholders was premised on the provision of a minimum capital, where it is stated that the Limited Liability Bill 1855, was but an amendment of the Joint Stock Companies Act 1844. By this amendment, Joint Stock Companies were to be enabled to limit the liability of all their members by complying with certain conditions intended to prevent ‘mere gambling bubbles’. The Bill which later became the 1855 Limited Liability Act.}

The minimum paid in capital requirement was received with divided opinions in both the House of Lords and House of Commons.\footnote{Refer to Hansard (1856) Vol CXL11 col 1489.} While the House of Lords favoured its introduction, members of the House of Commons voted by a large majority to remove the requirement originally inserted into the 1855 Act. Members of the Commons arguing for a repeal of s 1 of the 1855 Act, contended that the minimum share capital contained too much ‘unnecessary protection’ and that, it could even lead to a situation where a monopoly was created in favour of large and wealthy companies.\footnote{Ibid.}
By reasons of the divided opinions of members of both Houses of Lords and Common, s 1 of the 1855 Act was repealed by the insertion of sections 3 & 13 of the 1856 Joint Stock Companies Act, which did not contain a minimum capital requirement. The 1856 Act was amended by the 1857 Companies Act with no new changes in the law. The later Act was itself repealed and consolidated in the 1862 Companies Act which ‘abolished’ absolutely the statutory minimum paid-in capital requirement and, also made some sweeping changes to the capital maintenance doctrine generally.

Though the minimum capital requirement may not provide adequate protection to corporate stakeholders, the removal of the requirement from the 1856-1862 Acts could be seen to have weakened the regulatory safeguards that aimed to protect the public from the consequences of limited liability. For example, Horritz lamented:

To anyone who has not an intimate knowledge of the history of the British company law, s 1 of the 1855 Bill and now the Act, made provision for regulation of the share capital which the 1856 and 1862 Acts repealed making the law to go parallel to those of continental company law in that, while the British limited company does not afford the safeguards which are considered essential by continental Acts- vis-, a minimum payment of a considerable part of the subscribed capital before registration of the company, this absence weakens the capital maintenance doctrine (emphasis added).

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19 (19 & 20 Vict, c 47). Sections 3 &13 of the 1856 Act permitted a company to be incorporated with limited liability provided that each of the minimum of seven subscribers to its memorandum had agreed to take at least one share, which could be of any value. Another dominant force against the insertion of the minimum requirement in the 1856 Act as well as in the 1862 Act was Robert Lowe’s introduction of the theory of ‘comprehensive liberality’. There, he took the view that the state should have a limited role in business life. His criticism also of the amount of the initial £20,000 in the Limited Liability Bill culminated in that amount being reduced to £250 in the 1855 Act. Lowe’s theory did not escape criticism from the House of Lords by Lord Montagle who doubted Lowe’s motive for the abrogation of the minimum capitalization requirement. According to Montagle’s submission for supporting the minimum share capital, he intimated that wherever in foreign countries such as America and France where limited liability had been established, the principle had been coupled with safeguards and limitations. He considered that the 1856 Act was responsible ‘for encouraging a host of adventurers with ‘shilling shares and five pounds capital’ to start up useless and mischievous companies to the injury of the public. (See generally, Hansard (1856) Vol CXLII, col 1489-91; Hansard (3rd Series) Vol 139, col 121, 131).

20 The Companies Act 1862 (25 & 26 Vict, c 89). The changes include amongst others: no legislative minimum capital requirement; abandoned the injunction upon a company to cease trading should ¾ of its subscribed capital being lost as previously under ss 1 & 13 of 1855 Act; prohibited all forms of reduction of capital, financial assistance and the acquisition by a company of its own shares; prevented a company from issuing its own shares at a discount. In abandoning the safeguards provided by the minimum capital requirement, the central ideology relied upon by both the 1856 & 1862 Acts for the protection of creditors and the public, was centred on disclosure and publicity of information about the company’s capital and its shareholders. It is important to take note of this legislation because it is from here that most common law jurisdictions are modeled. (See for example the Companies Acts 1864-1964 Australia; Companies Acts 1926-1973 South Africa; Companies Act 1955-New Zealand and those of most Canadian jurisdictions).

The minimum capital requirement remained conspicuously absent from subsequent company statutes until 1962 when it came up again for consideration by the Jenkins Committee.\textsuperscript{22} The Jenkins Report initially favoured the re-introduction of the minimum capital requirement. In acknowledging the views expressed by some of its members, the Committee considered that under-capitalisation was a major cause of business failures and as such, a statutory minimum capital, paid-up in cash, would prevent the launching of at least some under-capitalised companies.\textsuperscript{23} Some witnesses argued that, while such a provision might be desirable in principle, it would be relatively easy to evade in the sense that, it would be difficult if not impossible to prevent a company, once formed with a statutory minimum of cash, from returning the cash to the promoters either in exchange for assets such as goodwill, or, by way of a loan or, in some other way.\textsuperscript{24} Although the Jenkins Committee favoured, in principle, a statutory minimum paid up capital, it refrained from recommending a stand alone minimum capitalisation on the reasoning espoused above by some of its members.

Nevertheless, in 1972, influenced by the Second European Community Company Law Directive\textsuperscript{25} and by a White Paper in 1973,\textsuperscript{26} the support for a minimum capitalisation requirement resurfaced. In its articles 6(1) & 6(3), the 2\textsuperscript{nd} EC Directive required member states to have a minimum capital requirement for public companies at £25,000 before they could commence business.\textsuperscript{27}

\textsuperscript{22} Jenkins Committee, \textit{Company Law Committee Report} (hereinafter, ‘Jenkins Committee’) Cmnd 1749 (1962) para 27. This Committee was established to review and report upon the provisions and working of the Companies Acts 1862-1948 and, to recommend what changes in the law were desirable.

\textsuperscript{23} Ibid.

\textsuperscript{24} Ibid paras 27-31.

\textsuperscript{25} The Second European Community \textit{Company Law Directive (Formation of Public Limited Companies & Maintenance & Alteration of Capital)} (13th December 1976) OJ L26/1; 779/EEC (henceforth, the 2\textsuperscript{nd} E.C Directive). It is importantly noteworthy that the E.C 2\textsuperscript{nd} Directive gained an influence during this period in restructuring and reviewing most of the Company law in continental Europe. All of the European Union Member States adhere to the capital maintenance doctrine (“legal capital doctrine”). The Second Directive imposes limits on minimum capital, contributions, distributions to shareholders, and increases or reductions in capital. However, as will be seen later, many Member States go beyond the Second Directive’s legal capital rules.

\textsuperscript{26} Department of Trade and Industry (‘DTI’), \textit{Company Law Reform White Paper}, Cmnd 5391 (1973). This paper took the view that a minimum paid-up capital of perhaps £1,000 would not only help to ‘ensure some minimum financial substance as a proper qualification for the protection of limited liability but, it would also act as a deterrent to frivolous incorporations.

\textsuperscript{27} This amount, it should be noted has not been increased since 1978 notwithstanding inflation. Compare the figures for example, of the following three member states (Belgium 2,500,000 Bef or 665,500 (Belgian Code; Italy 200,000,000 Lira-equiv: €100,000 (CODICE CIVILLE art 2327); UK £50,000—approx €74,000, Company’s Act 1985, ss 117, 118)). Also see, a tabular illustration of the status of the minimum capitalization statutes in some EU and American states, below at 296. A number of those EU States such as
This minimum capital requirement which was a condition precedent for commencing business must only consist of assets capable of economic assessment. Art 7 of the Directive further requires that the minimum capital must be formed exclusively out of cash contributions, or out of fixed assets. Undertakings to perform work or supply services may not form part of those assets. In accordance with art 9(2), at least ¼ of the subscribed capital must be paid up at the time of incorporation. Art 9(2) adds that contributions in kind must be paid up in full within five years after the incorporation of the company.

By art 10 (1), when the consideration is in moneys’ worth, the Directive requires that one or more independent experts be appointed or approved by an Administrative or Judicial authority for the purposes of valuing the shares and creating a report. Such a report must contain a description of the assets and the method of valuation. The report must also contain information on the value of the asset and whether it corresponds with the number and nominal value or, accountable par of the shares to be issued. Although the 2nd Directive does not require an increase in this amount, the company laws of most member states have adopted the 2nd Directive with variations in the minimum amount with some, fixing the minimum requirement at present at a higher minimum amount-sometimes, up to €100,000 or more.
The idea of extending the 2nd Directive to private companies has been floated but rejected to date.\textsuperscript{29} With certain exceptions,\textsuperscript{30} most of the requirements of the 2nd Directive were adopted and inserted as sections 22(1) and 85(1) of the \textit{Companies Act 1980}.\textsuperscript{31} The provisions of the 1980 Act were repeated in the 1981 \textit{Companies Act} and later consolidated in the current \textit{Companies Act 1985} as sections 11, 117 and 118. The \textit{Companies Act 1985} did not contain new law; its aim was to present existing law in a more accessible format.\textsuperscript{32}

\textsuperscript{29} Although the 2nd EC Directive is not applicable to private companies, some member states have similar rules for them. (For example, Germany imposes a minimum capital for both the public company (AG) at DM 100,000 (approx. £52,000) & DM 50,000 for private company (GmbH). In Denmark, a sum of 200,000 Danish Kronas is set for private companies, approx. £28,000). In this regard, see a landmark decision in E.C Law: \textit{Centros v Erhvervs-og Selskabsstyrelsen [1999]2 CMLR 551.586-587} wherein, the Danish government sought to justify their country's minimum capital laws. For a detailed discussion of the \textit{Centros} case, see for example, WYMERSCH, "\textit{Centros: A Landmark Decision in European Company Law}" in T. BAUMS, K.J. HOPT & N. HORN (eds.), \textit{Corporations, Capital Markets and Business in the Law}; (2000) 629.

\textsuperscript{30} 2nd EC Directive, art 10(4) contains a very narrow exception to the requirement of art 10(1) designed to cater to certain intra-group issues and corporate reorganizations involving the creation of a subsidiary. Arts 23 (4) of the 3rd Directive which must be read in conjunction with the 2nd Directive, provides for a further exception concerning the formation of a new company 'to acquire an existing company or companies by mergers. (Refer to the 3rd Council Directive (1978) Q1 [1.295] 78/885, para 41. This exception provided by the 3rd Directive was proposed by the SLIM Working Group. (Refer to SLIM, \textit{Company Law}, Working Group Recommendations of the Simplification of the First and Second Company Law Directives (1999) 3, 4 <http://www.law.rug.ac.be/fil/SLIM.pdf> at 20 October 2001.

Section 22(1) of the 1980 Act requires public companies to allot shares as paid-up to the extent of at least one quarter of their nominal value; and the whole of any share premium payable of them. This import an obligation on the part of the allottee to pay up on allotment not less than the statutory fraction of the issue price and a corresponding obligation on the company to exact the payment. This requirement supersedes the former rule that where shares are offered by a prospectus at least 5% of their nominal value must be paid up on application (see for example, s 47(3) of the Companies Act 1948 now repealed by s 88(2) of the 1980 Act). See also, ss 1 & 3(2) of the 1980 Act which sets out the nominal capital for public companies at not less than £50,000. Section 85(1) fixes the authorized minimum for public companies at £50,000, of this amount; at least ¼ must be paid in as the minimum paid in capital (which is the equivalent of £12,500).

\textit{Company's Act 1983}, s 117(1) which now contains the basic requirement restates the previous Act by requiring every company originally registered as a public company to be forbidden to do business or exercise any borrowing powers until the Registrar of Companies has issued it with a certificate under s 117 or it has been re-registered as a private company. (In other words, to obtain a s 117 certificate, a company must satisfy the Registrar that its allotted share capital is not less than the authorized minimum, then must deliver to the Registrar a statutory declaration complying with the requirements of s 117(3)). Sections 117(3)& 118 (1) defines the authorized minimum as being £50,000, which can only be altered by the Secretary of State and, at least ¼ together with the whole of any premium at which the shares are issued must have been paid to the company in money or money's worth before commencing business. Section 11 prevents a public company being registered unless its memorandum has an authorized capital figure not less than the authorized minimum. While ss 117 & 118 fixes the authorized minimum at £50,000, s 101 prescribes the ¼ paid-in minimum. (According to this section, a public company is forbidden to issue a share unless it is paid up as to at least one-quarter of its nominal value and the whole of any premium on it). A detailed analysis of s 101 reveals some drafting imperfections in the application of ss 117 &118. Also, despite the power to alter (meaning for all practical purpose to increase the minimum figure), the 'DTI' has not taken the opportunity do so like other EU Member States and, the figure remains as set out in the 1980 Act. Accordingly as one commented noted, it might well be regarded as being somewhat out of date, given the changes in the value of money which have taken place since then (A. McGee, \textit{Share Capital}, (1999) 5. In accordance with the valuation of non cash minimum share capital, s 108 re-insert s 10(1) of the 2nd EC Directive, requiring an independent 'expert valuation'.

\textsuperscript{31} \textsuperscript{32}
Although it is not necessary that share capital be designated in sterling, or a single currency, the public company must have at least £50,000 of its capital expressed in sterling to satisfy ss 117 & 118. It is unclear why the minimum capital must only be denominated in one currency for, there is apparently no reason why such a capital cannot be denominated in mixed currencies as espoused by Harman J in Re Scandinavian Bank Group Plc.\textsuperscript{33} For the purposes of ensuring that the minimum capital requirement was ‘nearer’ to a ‘capital adequacy’ requirement, s 142 was inserted into the current Act, requiring the directors of a public company whose net assets are reduced to half of its called up share capital, to convene an extra-ordinary general meeting so as to consider a similar approach of either recapitalising or reorganising used by other European member states jurisdictions.\textsuperscript{34}

The 1985 Act was revised by the Companies Act 1989. However, that Act contained no significant changes to the capital maintenance doctrine. While the 1985 Act remains the force behind the capital maintenance doctrine, a critical inquiry into the adaptability of a statutory minimum capital requirement reveals potential weaknesses which require drastic statutory review.

Most EU Member States all seem to agree that companies should have sufficient assets to be able to satisfy the claims of their creditors. Yet, there are different views on how this objective should be achieved. Certain member states have adopted the view that companies need to maintain a certain minimum capital reserve in order to do business. This requirement provides for an entrance threshold for establishing a company. The idea is that a shareholder must pay a certain amount of money into the company in order to be granted the benefit of limited liability. There are also rules to ensure that the minimum capital is preserved throughout the company’s existence.

\textsuperscript{33} [1988] Ch 87; [1987] 2 All ER 70.

\textsuperscript{34} As earlier indicated, the effect of s 142 is to attempt to impose something approaching a capital adequacy requirement by requiring a company to maintain a specified level of net assets. Arguably, as will be seen in subsequent discussion of this paper, this rarely applies in practice because of the very low threshold set. One commentator even argues that s 142 will only apply in extreme cases because the called up share capital as so defined will usually be only a very small part of the financing side of the balance sheet (To this effect, see, E. Ferran, “Creditors’ Protection and ‘Core’ Company Law” (1999) 20 Company Lawyer 318, 319).
In contradistinction to the EU Member States, in other common law jurisdictions, (like, Australia, South Africa, New Zealand and some American States) there is no statutory minimum capital requirement as a condition precedent to the existence of a corporation.

For comparative purposes, when the minimum capital was required by the 2nd EC Directive for the 'EU' Member States in 1976, and enacted by the Companies Act 1980 (UK), the Australian Company and Securities Law Review Committee (C&SLRC), Forms of Legal Organisation For Small Business (1984) Discussion Paper No 1, received a general reference from the Ministerial Council to inquire into the desirability and extent of a minimum paid-up capital for its jurisdiction. After taking the view that a company can still be adequately capitalised yet lose its paid-up capital in the normal course of trading, the C&SLRC submitted that it was doubtful whether a requirement for a minimum paid-up capital can fulfill any function. See, C&SLRC (ibid)para 341 at 32-37. The C&SLRC advanced various reasons why there should be no minimum capital requirement for Australian companies. For example, the Committee considered that the minimum capital requirement in the UK and other European States was implemented to discourage frivolous incorporation and not to ensure a substantial capital base. The Committee further intimated that even if it was possible or desirable to set a minimum capital, the amount appropriate for some types of companies may be quite low and therefore, be discriminatory. The Committee therefore suggested that a better way to protect creditors may be to make directors of an insolvent company liable without limit where they have either failed within a reasonable time to cause the cessation of the company's business, to call a meeting of members and creditors or, to arrange for adequate capital to be paid into the company (at para 449). (For many other reasons why the C & SLRC could not recommend a minimum capital in similar lines to the EU Member States, see C&SLRC Report (ibid) paras 341-352). It is to be noted that the Australian Stock Exchange Listing Rules (ASX, LR) 2.1; LR 1.1 Condition 7 provides a minimum capital requirement for limited liability companies quoted on the stock exchange. Listing Rule 3(b) for example, provides that a company seeking official quotation of shares may be considered for admission to the official list if the issue price of each share for which official quotation is sought is at least 20c (LR 3(b)(1)) and, there are at least 500 shareholders each with a parcel of shares having a value of at least $2000 and, the company is a going concern or, successor of a going concern, which has an aggregated operating profit before tax for at least three full financial years of at least $41,000,000 and operating profits before tax for the 12 months expiring at the end of the month immediately preceding lodgment of an application for admission to the official list, of at least, $400,000 which an investigating accountant must certify (LR 3(a)). The company must also have net tangible assets of not less than $2 million.

Unlike Australia, in the United States (US), State corporations Acts genereducted as to the desirability of a minimum capitalization requirement. For many years in the U.S, the concept of the minimum capital has been sponsored by the Committee on Corporate Laws of the American Bar Association which sought to require a paid in minimum share capital of $1000 before a corporation could commence business (See, ABA-ALLI, MODEL BUS CORP ACT, §51.2.02(2) (1960)). The recommendations of ABA-ALLI Committee were adopted by most US Statutes prior to the Model Business Corporations Act ('MBCA') (1970) whereby, they require the articles of association of the corporation to specify a minimum paid in capital as a pro forma requirement to be initially paid in by shareholders as a condition to conducting business and, persons who organized corporations without this were made liable to creditors. (For example, refer to the Corporations Law of Louisiana, Minnesota and Indiana which each required a minimum paid in capital ranging from $500-$1000). However, due to the growing recognition that adequate capitalization is a problem beyond the capacity of a general statute, most state laws gradually abandoned such minimum capital requirements. The result was that in the 1971 version of the MBCA, s 5493.03(7) no longer required corporations to pay in any capital prior to commencing business. The Law Review Committee also dropped the minimum capital requirement from its agenda on the grounds that the protection sought to be achieved was illusory and the Model Business Corporations Act ('MBCA') ANNOT s 6.21 (3rd 1989). Like in Australia, Publicly-held corporations listed on the New York Stock Exchange (NYSE) must satisfy a minimum capitalization requirement of $5,000,000 in net assets and an average net income after taxes of over 4400,000 for $23,727 at A291-96, 2CCH). For a tabular illustration of the statutory minimum capitalization requirement in some European and American states see tables 1 & 2 on page 296 (below).

Table 1: European Member States.

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Company</th>
<th>Private company</th>
<th>Statute</th>
<th>Amount in Euro_</th>
</tr>
</thead>
<tbody>
<tr>
<td>Britain (UK)</td>
<td>£50.000</td>
<td></td>
<td>Companies Act 1985, as 117-118</td>
<td>74.000approx.</td>
</tr>
<tr>
<td>France</td>
<td>SA 250.000FF</td>
<td>S.ARL 50.000FF</td>
<td>Law of March 27th 1967 &amp; of July 24th 1966 as amended by Company Simplification Public company Amendment Act 1994</td>
<td>38.112/228.867/9.000</td>
</tr>
<tr>
<td>Germany</td>
<td>(AG), DM100.000</td>
<td>GmbH, DM 50.000</td>
<td>S.7 Aktiengesetz</td>
<td>52.000/ 26.000</td>
</tr>
<tr>
<td>Denmark</td>
<td>400.000DKR</td>
<td>200.000DKR</td>
<td></td>
<td>56.000/ 28.000</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.500.000BEF</td>
<td>100.000BEF</td>
<td>Art439 W.Venn</td>
<td>62.000/ 23.000</td>
</tr>
<tr>
<td>Italy</td>
<td>2000.000.000</td>
<td>100.000.000</td>
<td>Art 2327 Codice Civile</td>
<td>103.291/ 56.138</td>
</tr>
<tr>
<td>Netherlands</td>
<td>100.000NGL</td>
<td>50.000NGL</td>
<td>Art 67 2 Beek 2Bw</td>
<td>45.378/ 27.675</td>
</tr>
<tr>
<td>Spain</td>
<td>10.000.000Esp</td>
<td>5.000.000Esp</td>
<td>Art 4LSA</td>
<td>74.195/ 37.612</td>
</tr>
</tbody>
</table>

Note: The UK does not legislate a statutory minimum capital requirement for private companies. However, it is assumed most private companies can be incorporated with figures as low as £1 up to a maximum of a £100 given them the name of a ‘£100 companies’. The Euro conversion is based on “CNN” financial statistics (CNN News) at 17 March 2005.

Table 2: Some American States before the MBCA of 1970.*

<table>
<thead>
<tr>
<th>State</th>
<th>Amount</th>
<th>Statute</th>
</tr>
</thead>
<tbody>
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<tr>
<td>Florida</td>
<td>$500</td>
<td>MBCA 608.56</td>
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Note: * Most of the states indicated were modelled in accordance with the Model Business Corporation Act (MBCA) prior to 1970. In recent times, the ‘Revised MBCA’ (RMBCA 1990) like other state corporations statutes in the US, makes no provision for a minimum capital requirement. For a detailed analysis of pre-1970 statutory minimum capital requirement and a full tabular illustration of most American Jurisdictions, see. B.E.D. “Statutory Minimum Capitalization Requirement” (1969) 5 Willamette LJ 333, 334.
6.3. Arguments for a Minimum Capital Requirement

6.3.1. Protect creditors & prevents frivolous incorporation

The legislative objective of imposing a minimum capital requirement is to give a signal about the suitability of incorporation as a limited liability company, so as to safeguard initially the creditors with a substance behind them.\(^{37}\) Because corporate shareholders are granted this privilege which makes them ‘judgment proof’ in personal liability except for the amounts unpaid on their subscriptions, to protect the creditors and the public, the law imposes this minimum amount as a safeguard.\(^{38}\) Creditors were thought to look to such a ‘guarantee fund’ as security and as a source of collection for payment of their claims in a situation of an early insolvency. Creditors have recourse against the shareholders to the extent of the unpaid amount of issued shares and the difference between the actual values of the property transferred in exchange for the shares.

The prescription of a minimum paid-up capital is assumed to be also an ‘entrance fee’ to commencing a limited liability company. To this extent, it is relevant to the general public as a means of keeping frivolous incorporation to a minimum.\(^{39}\) By acting as a barrier to formation, the minimum capital requirement may also serve in preventing the abuse of the privilege of limited liability. Shareholders are also assumed to be protected from personal liability for the debts of the corporation in the sense that, their liability is limited only to the amount of any shares remaining unpaid.

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\(^{37}\) The creditor protection safeguard focuses on the notion that the minimum capital serves as a reference point for certain number of decisions especially limiting distribution to the undistributable net assets (see for example, art 15 of the 2\(^{nd}\) EU Directive which is to the effect that, a minimum capital requirement contributes to protects creditors against the directors siphoning off financial substance in favour of the shareholders). It may be posited that the absence of ‘capital’ is reflected in a higher propensity to become insolvent. Therefore, a point may be made for requiring an initial share capital that would only be applicable to the smallest firms organized as limited liability corporation. The larger firms would in that hypothesis be exempted. Ironically, that argument is weak because the 2\(^{nd}\) EU Directive requests exactly the opposite. For a summary of the legislative objectives of how the minimum capital requirement could protect creditors and shareholders see, above n 14.

\(^{38}\) With the general acceptance of the doctrine that one could risk a specified amount of capital in a commercial venture without thereby engaging his private fortune as security for the success of the enterprise, presumably, this model of corporateness requires both economic viability and the observance of certain procedural formalities. Under the category of economic viability is perhaps the justification for a corporation to have a minimum capital so as to carry out its intended business. The rationale being that creditors look to such funds as a source of collection.

The effect is that investors of capital (shareholders in this sense), could use the corporate body as protection against financial risk. This policy objective centres on the notion that the combination of the minimum capital requirement and limited liability constitutes a break on frivolous formation of business enterprises with shareholders being protected against the consequences of their ill considered plans.

6.3.2. Serves as a Signalling device

The European styled minimum capital is based on the notion that shareholders must pay a price to obtain the benefits of limited liability. Under this view, limited liability is considered a privilege which benefits shareholders, but hurts tort claimants and other creditors. To obtain this benefit, shareholders must make minimum contributions of this minimum paid in capital to the company and the company may not return these contributions to the shareholders during the company’s life.\(^40\) Alternatively, it is also theoretically conceivable that rules mandating a minimum share capital can be seen as a response to an externality resulting from limited shareholder liability.\(^41\) It is presumed that by ensuring that firms have at least a certain minimum level of assets available to satisfy creditors, shareholders are prevented from undercapitalising firms and the law’s ability to correct externality is enhanced.\(^42\)

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40 This common law rule is to the effect that the corporate form of organization does not contemplate the doing of business with the entire exemption of the shareholders from liability for debts. This it is assume, serves as a signal to members that despite the privilege of enjoying limited liability, they are supposed to make an ‘adequate’ contribution to the capital of the concern to meet the risks of the business. This is the security which the policy of the law enacts when it grants the special privilege of liability which is limited to the shareholders’ investment. (It is to be noted that the adequacy of this required contribution is doubtful).

41 Externalities are costs which economic actors impose on others in such a way that those costs are not mediated by market processes. Some areas of law, for example tort or environmental regulation, can be viewed as systems which impose ‘prices’ on activities that are socially harmful so as to encourage actors to internalize their social costs. In the corporate context, limited liability may result in corporate shareholders being able to avoid liability for torts and environmental damage committed by their company, and hence undermine the law’s ability to correct these externalities. (Refer generally to, H. B. Hansmann and R.A. Kraakman, “Towards Unlimited Shareholders Liability for Corporate Torts” (1991) 100 Yale Law Journal 1879; J. Armour, ‘Chapter 6-Capital Maintenance’ (2000) Working Paper Series, Centre for Business Research (ESRC) University of Cambridge. <http://www.dti.gov.uk/eld/may2000/chapter6may.pdf> at 2000.

42 The minimum paid-in capital is also assumed to be a response to certain perceived abuses associated with the formation of some “$2” companies. "$2 companies” is a term used to describe limited liability companies in certain common law jurisdictions like Australia and New-Zealand, who do not impose a minimum capital requirement. There, there is a ‘general saying’ for companies to operate and commence business with a share capital as low as $2. It could even be lower given that a company only has to have one member who holds a minimum of one share in Australia.
Absent any judicial pronouncement or empirical evidence, it does not seem that the amounts of paid-up capital required by the Companies Acts or the 2nd EC Directive would offer much protection to creditors. Certainly, sophisticated lenders would not provide a loan to a corporation on whether the minimum capital has been paid in prior to commencing business. The concept might have some validity if it was applied uniformly to all corporations, yet, the reasoning would seem defective when uniformity is absent.43

6.3.3. Facilitates borrowing.

Another argument advanced in support of a minimum paid-in capital may be that the initial amount contributed might enable a company to have a chance of survival in a competitive market to the extent that it may facilitate borrowing opportunities soon after incorporation. By so doing, a company could easily expand through borrowing. Although it will be argued in the next sub-part of this paper that creditors do not check the capital before contracting with the company, to a certain extent, it might be counter-argued that creditors do indeed check the ‘capital’. The company will, for example, not obtain any credit from say, a bank if the ‘capital’ (i.e., net assets rather than share capital) is conspicuously absent or insignificant.44 The banks will insist on the shareholders guaranteeing the loan it grants therefore, piercing not the veil of incorporation but the limited liability which the shareholder has contracted for.

43 See, for example, New Jersey STA. ANN 14:7-3(e). In a majority of US cases, the courts took the view that a failure to comply with the requirement does not negate corporate existence: W.L. Wells Co v Gastonia Cotton Mfg Co, 198 US 177 (1905); Temple Enterprises Inc v Combs, 164 Or 133 (1940). The US Court of Appeals for the Eight Circuit decided that under the Minnesota statute, the fact that the capital stock had not been paid in did not deprive a bankrupt corporation of its status as a de jure corporation which could validly enter into a loan agreement: Tarutis v United States, 354 F.2d 546 (1965).

44 Where limited liability and outside finance are real objectives, a minimum capital requirement might assist the intending entrepreneurs. If for instance, an entrepreneur incorporates with no ‘capital’, they are likely to find that they will not obtain de facto limited liability because security will be demanded of them by lenders or others (i.e., 3rd parties will contract around the regime, being an unsuitable standard form). In addition, prospective outside investors will probably demand some sign of commitment, so that the investor may find the supposed benefits of incorporation can be costly in administrative and tax terms. On this reasoning, a minimum capital requirement could save business owners from inappropriate incorporation and therefore be ‘deregulatory’ in practice. (Refer to, J. Freedman, “Small Business and the Corporation Form: Burden or Privilege?” (1994) 57 Modern Law Review 556).
6.3.4. Act as a capital adequacy & asset backing requirement.

The imposition of a minimum initial share capital requirement by limited companies bears a relationship to the capital maintenance principle- by serving as a minimum initial level for the capital that is to be maintained. This, it is assumed would protect creditors in the sense that preserving the initial capital was thought to reduce the chances of early insolvency and therefore, minimise creditor’s losses. While there may be no doubt that the words of the legislation for imposing a statutory initial capital requirement may be intended to have a broader application, in the Centros case for example, the European Union (EU) Members states all seem to agree that companies should have ‘sufficient’ assets to be able to satisfy the claims of creditors. This is supported by s 142 of the English Companies Act 1985, which imposes a provision that can be analogous to a capital adequacy requirement.

The effect of this provision is that it requires the directors of a public company which has suffered a serious loss of capital (i.e., its net assets are half or less of its called up share

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45 Capital adequacy, in terms of newly formed corporations, has been defined to mean the separate assets sufficient to give it at least a reasonable business chance to carry out its asserted functions (refer, to W.P. Hackney & T. Benson, “Shareholders Liability For Inadequate Capital” (1982) 42 University of Pennsylvania Law Review 837, 889). Some Proponents of the EU minimum capitalization requirement assume that the purpose of such a requirement is for it to represent a capital adequacy requirement in the sense that it would protect those creditors who have no market power (in other words, it is useful in order to protect the 'weakest creditors'-those with little or no bargaining power vis-à-vis their public limited liability company counterparts. ('Weakest creditors here will refer to those creditors who are unable to protect themselves by contract, such as, trade creditors, employees and other involuntary creditors). (See generally, J. Keustermans, “Countertrends in Financial Provisions for the Protection of Corporate Creditors: The MBCA & the E.E.C. Corporate Directives” (1986) 14 DENY Journal of International Law & Policy 275, 289; L. Enrique & J. Macey, “Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules” (2000) 86 Cornell Law Review 1164, 1201.

46 The original purpose of laws affording limited liability to corporate owners, and for imposing such a minimum initial requirement was to enable shareholders to put at risk the business a minimum capital ‘reasonably adequate’ for its needs while keeping free from that risk their un-invested assets and their personal responsibility. The objective was also to ensure that controllers of business have a substance behind them.-This reasoning however may not sound too compelling because, in theory, a company may comply with a minimum capital requirement and yet still have financially weak controllers. The controllers may, for example, invest all of the capital raised through share issues in risky assets such as lending to a borrower with a poor credit rating without infringing the maintenance of capital principle. If this supposition is correct, then it may be said that the capital maintenance rules do not require a company to hold a certain amount of its capital against its assets. However, restricting the claims of creditors to invested capital may be deemed consonant with public interest, and a fair compromise between the desire of investors for the fullest immunity and the desire of creditors for the fullest needs of satisfaction. More reasons for implementing the share minimum capital can be found in Hansard (1854) Vol CXXXIV 764, 800; Hansard (3rd Series) Vol 139, cols 1389, 1390; Hansard (1856) Vol CXLI, cols 1489-91. Support for the ‘asset backing’ reasoning can be found in the US authority of Costello v First, 256 F.2D 903, 908 (9th Cir, 1958). There, the term ‘capital’ is used to refer to the measure of the amount of the margin of assets or debts and liabilities required to be retained as a condition of granting the shareholders the privilege of trading in a corporate capacity with limited liability.
capital), to call an extraordinary general meeting to consider what steps to take so as to maintain a specified level of its nets assets. The above 'capital adequacy' analogy is reinforced by the so called 're-capitalised or 're-organised' ('liquidate') rules adopted by most member states. According to these rules, the minimum capital requirement seeks to ensure that at least a minimum level of assets is contributed to a public company by its shareholders and that if for any reason(s) the company's net worth should subsequently fall below a threshold level, then, steps should be taken by the company directors to remedy the situation.

The remedy is for the company to either recapitalise or reorganise into a type of company with a legal capital no greater than the remaining net assets. If a company does not carry out such a reorganisation or recapitalisation in a timely manner, these rules require the company to be wound-up, or they impose personal liability on the directors. In spite of the legislative policy manifested in the statutory minimum, a corporation's compliance

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47 See, the Italian , Swedish and French examples, above n 26, (relating to re-organisation and recapitalization). Apart from s 142 of the 1985 Company's Act (UK), which requires something closer to a capital adequacy requirement, other continental European laws adopt a similar approach. See Companies Acts of jurisdictions like; France (French Commercial Code, Law No 66/537-776236, (July 1966) art 1 225-248 (as amended) which provides for dissolution if a company experiences losses greater than half of the subscribed capital, unless, the company reduces its capital correspondingly within two financial years and the resulting capital is higher than the minimum statutory capital. (In other words, French law does not require dissolution if the company recapitalizes itself so as to reach this amount in cases of higher losses. A company may also avoid dissolution by converting into another kind of company. (For full discussion on the French rule, see, S. Rees, "Company Law's Role in Economic Development: The French Approach" (1994) 68 Australian Law Journal 777, 778; Yves, Guyon, Francaise des Societes avec la Directive des Communistes Europennes sur le Capital Social, [1982] LA SEMAINE JURIDIQUE 3067 paras 19-20. The Italian Civil Code (Codice Civile 'C.c'), provides for dissolution if a company experiences losses greater than the minimum statutory capital, unless the company recapitalizes or converts into another kind of company with a lesser or nonexistent capital requirement (C.c arts 2447, 2448(4). Spain imposes dissolution when a company experiences losses that are higher than half of its subscribed capital, unless the company reduces its capital requirement or increases its capital on hand sufficiently within two months by a general meeting of its stockholders (See, Corporations Law arts 260(1), 260 ( BOLETIN OFICIAL DEL ESTADO [B.O.E.], (1989), 310. Sweden has a similar rule. See, J.Armour, "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law" (2000) 63 Modern Law Review 355, 371 "[I]f the net assets of a Swedish company fall below half its share capital, then the shareholders must either inject fresh equity to restore the net asset level, or liquidate the company."). This approach, it is presumed can act to protect creditors without their even being aware of its existence (J. Armour, (ibid) 365). Such a move might be seen also as a means of protecting both voluntary and involuntary creditors (D.D. Prentice, "Corporate Personality, Limited Liability and the Protection of Creditors" in Granham & Ricketts (eds) Corporate Personality in the 20th C (1998) 93, 103. (For a detailed & critical analysis of the EU Legal capital rules see, E. Mymers, "European Company Law: The Simpler Legislation for the Internal Market [SLIM] Initiative of the EU Commission" (Working Paper Series. See also, L. Enrique's & J.C. Macey, "Creditors Versus Capital Formation: The Case Against The European Legal Capital Rules" (2001) 86 Cornell Law Review 1165, 1185-90; V. Edwards, E.C. Company Law (1999); Christopher Van der Elst, 'An Analysis of Corporate Law in Europe: 'An Introduction' (Working Paper Series, Financial Law Institute, The University of Kent, 2002) 8-20.
with a minimum capital requirement does not create a presumption of adequate capital, nor will it shield a corporation from attack as being inadequately capitalised during insolvency proceedings.\textsuperscript{49}

6.3.5. Can be used to Pierce the Corporate Veil

Limited liability may be denied to the shareholders of a company in a corporate group when courts decide to impose liability on managers by lifting or piercing the corporate veil.\textsuperscript{50} The traditional situation in which the veil is pierced in some form is when the courts allow a creditor of the corporation to hold its shareholders liable for obligations of the corporation by reaching the assets of shareholders. This is used at times to hold shareholders liable and at other times, to impose liability on managers especially where the company is believed to be undercapitalised or, inadequately capitalised.\textsuperscript{51} However, the justification for this may be obscured since state law typically says that limited liability is absolute.\textsuperscript{52}

Another difficulty with this strategy is that it usually only occurs in close corporations\textsuperscript{53} and, is used only after a wrong has been committed and usually, only in

\textsuperscript{49} For example see, the US case of Taylor v Standard Gas & Electricity Co ("Deep rock case"), 306 US 307 (1939). Refer also to, D. J. Wetterbeck, "The Inadequacy of Stated Capital Requirements" (1971) 40 Cincinnati Law Review 823.

\textsuperscript{50} In the US and other continental jurisdictions, undercapitalization has been the basis or a contributing factor in piercing the corporate veil in a number of cases: Luchenbach S. S. Co v W.R. Grace &Co, 254 US 644 (4th Cir, 1920); Pepper v Litton,308 US 295 (1939); Stafford v Otto Sales Co, 149 Cal App 2d 428 (1957). For example, in Claremont Press Pub Co v Barksdale, 187 Cal App 2d 813 (1960), shareholders were held liable for corporate debts where the corporation was found to have commenced business without the required minimum paid in capital.

\textsuperscript{51} Easterbrook and Fischel, see this as a measure of controlling socially excessive risks taking (Refer to, F. H. Easterbrook, and D. R. Fischel, The Economic Structure of Corporate Law (1991)14-15. The reasons for allowing the courts to go beyond the corporations assets as a result of the companies capitalization is simple and clear-the lower the amount of the firms' capital, the greater the incentive to engage in excessively risky activities. (See also, Whincup, 'Inequitable Incorporation-The Abuse of Privilege' (1981) 1 Company Lawyer 158,158). For empirical evidence, see, R.B. Thomson, "Piercing the Corporate Veil: An Empirical Study" (1991) 76 Cornell Law Review 1036, 1037; Mitchell, 'Lifting the Corporate Veil in the English Courts: An Empirical Study' [1999] Corporate Finance Law Review 15.

\textsuperscript{52} See, for example, DEL CODE ANN tit 8, §152 (1983); MODEL BUS CORP ACT §6.22 (1984). There, it is stated thus: 'a stockholder is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which such shares were authorized to be issued'. Also, as illustrated in the English case of Salomon v Salomon [1897] AC 22, once a corporation is duly incorporated, the courts usually do not look behind the veil to inquire why the company was formed or, who controls it. In this case, the corporate veil ensures that the shareholders are not personally liable to creditors for the companies' debts.

\textsuperscript{53} Almost every case in which a court has allowed creditors to reach the assets of shareholders has involved a close corporation ("Almost every" is used here because not all corporations are examined- The most famous cases where piercing was an issue close corporations). See, Minton v Cavaney, 56 Cal 2d 576 (1961); Barrle v Home Owners Cooperative, Inc, 309 N.Y. 103 (1955). The classic US case of Walkovsky v Carlton, 18
extreme cases. Though a significant minimum share capital might, however, encourage business owners to take proper advice on set-up, obtaining such advice would have its own ramifications and cost. It could also have many beneficial effects including awareness of statutory measures that might result in personal liability. However, such an ‘absolute’ rule can lead to undesirable consequences. If a company incurs debts which cannot be paid, it is the creditors who bear the loss particularly so if the company is limited by shares or guarantee. To this effect, it can be concluded that the doctrine of piercing the corporate veil, may be understood at least roughly, as an attempt to balance the benefits of limited liability against its costs. Courts are more likely to allow creditors to reach the assets of shareholders where limited liability provides minimal gains from improved liquidity and diversification while creating a high probability that a firm will engage in a socially excessive level of risk taking although, this would not stop rogues from attempting to abuse limited liability. Other measures would still be needed.

6.3.6. A Risk Allocation Device

Another theoretical backing for a minimum paid in capital is premised on the idea that it serves as a risk allocation device. Shareholders are forced by law to commit their funds irrevocably to the business and hence are to bear the appropriate risks of business failure. They will not be permitted to shift this business risk to the corporate creditors by depleting the share capital. But since there is no guarantee that the initial capital will be maintained and not lost in the course of business exigencies, it may be difficult to judge the relevancy (accuracy) of this justification.

NY.2d 411-414 (1966) is a good introduction to some of the problems arising in the use of the piercing of the corporate veil.

Easterbrook and Fischell, “Limited Liability and the Corporation” (1985) 52 University of Chicago Law Review 89, 109-113. See also, Douglas and Shark, “Insulation from Liability through Subsidiary Corporations” (1929) 39 Yale Law Journal 193, 210-211 who is of the opinion that courts are more willing to disregard the corporate veil in tort than in contract cases. The difference in judicial treatment of torts and contract cases was noticed in Edwards v Monogram Industry, 730 F.2d 977 (5th Cir 1984). (The rationale for this distinction follows directly from the economics of moral hazard—where corporations must pay for the risk faced by creditors as a result of limited liability. Tort creditors, on the one hand, are less likely to engage in activities with social costs that exceed their social benefits. In other words, contract creditors, are compensated ex ante for the increased risk of default ex post. Tort creditors, by contrast, are not compensated). Another commentator is of the view that, the greater willingness of courts to allow creditors to reach the assets of the corporation as opposed to personal shareholders is consistent with economic principles (Hackney & Benson, “Shareholder Liability For Inadequate Capital” (1982) 43 University of Pittsburg Law Review 837, 873).
6.4. **Arguments against a Minimum Paid-up Capital**

By obliging public companies to have and maintain a minimum paid in capital, the 2\textsuperscript{nd} EU Directive judged the advantages of the maintenance of such a statutory minimum share capital to be higher than the disadvantages. However, developments in contemporary modern statutes and the availability of greater creditor protection mechanisms, mean that the traditional justifications are flawed.

6.4.1. **Illusory Protection to Shareholders and Creditors**

The original policy rationale justifying the imposition of a minimum paid in capital as a means of protecting creditors and even shareholders of limited liability companies is open to doubt.\textsuperscript{55} The minimum paid in capital was suggested to set not only the limit on liability for shareholders in the event of insolvency but, that creditors would look to it as a fund for security of their claims. The most the minimum paid in capital can offer is limited protection to prevent early insolvency. However, the recourse of relying on the minimum initial paid in capital as a means of protecting creditors, it may be argued, is unlikely to succeed, because a company can still be adequately capitalised yet lose its paid-up capital in the normal course of trading.\textsuperscript{56} Furthermore, even if it was possible to set a minimum capital, the amount appropriate for some types of companies may be so low that creditors would receive at best token protection.\textsuperscript{57}

\textsuperscript{55} The Second Directive’s minimum initial capital requirement provides no meaningful protection for creditors (cf D. D. Prentice, “Veil Piercing and Successor Liability in the United Kingdom” (1996) 10 Florida Journal of International Law 469, 470., characterizing the £50,000 that the 1985 Companies Act requires U.K. companies to have as minimum paid in capital as “insignificant”). Gower & Davies, who argued that, the minimum capitalization operates, by definition, when the company begins trading and that, the minimum capitalization at the time the company commences trading does not guarantee any particular level of assets backing available for the creditor at this later date, since, no legal capital requirement of, say £3000 for a private company, even paid in cash, could soon be returned to the incorporators by means of salary payments for services rendered to the company (Directors remuneration would not usually be caught by the rules controlling distribution by companies). (Refer to, Gower and Davies, Principles of Modern Company Law, 7\textsuperscript{th} ed, (2003) at 228, 229.

\textsuperscript{56} Some critiques may take this as an unwarranted criticism. This may be premise on the notion that the creation of the legal capital doctrine was never intended to protect creditors from the fact that the capital of the company may not be lost by expenditure made in the course of carrying out the business. This is a risk that creditors must bear for they are, after all engaged in the making of capital investments and there is always risks associated with that investment. If there was any such a criticism, it would be unfounded because, it does not cancel the fact that the minimum paid in capital was never intended to act as a ‘guarantee fund’ for the protection of creditors.

\textsuperscript{57} The amount of the minimum capital required by some EU Member States is so insignificant in that it is unrelated to the debt that a company may incur. Consistent with this, is the views expressed by some commentators (see for example, the “C&SLRC”, Forms of Legal Organisation For Small Business, above n 34; J. C. Bombright, “Earning Power as a Basis of Corporate Capitalization” (1921) 35 Quarterly Journal of Economics 482; E. Wymeersch, “Some Recent Trends and Developments in Company Law” (Working Paper
Absent empirical findings, the protection offered by the minimum capitalization regime is illusory.\textsuperscript{58} This criticism may be inspired by the observation that in some jurisdictions, companies function as well without any minimum paid in capital.\textsuperscript{59} Moreover, while a minimum capital may seek to offer limited protection to consensual creditors;\textsuperscript{60} it fails to protect tort claimants. The obvious difference between consensual and non-consensual transactions is that the claimants in a consensual transaction generally have chosen the parties with whom they have dealt and have some ability, through personal guarantees and security agreements to protect themselves from loss. In non-contractual cases, there is no element of voluntary dealing and the question is whether it is reasonable for businessmen to transfer a risk of loss or injury to members of the general public through the device of conducting business in the name of a corporation that may be marginally financed. There are some ‘weak trade creditors’ and employees lacking adequate bargaining power. For such individuals, however, the European rules requiring initial minimum capital of €25,000 are of very little, if any, help.\textsuperscript{61}

Creditor protection is also illusory because in most cases, creditors do not look to the minimum capital to determine whether to give credit or not to a limited liability company.\textsuperscript{62} Creditors of limited companies are influenced more by the company’s


\textsuperscript{59} Some legal and economic writers have adopted a thoroughly cynical attitude towards the minimum paid in capital requirement, labeling it as 'inefficient', 'illusory' and 'irrelevant'. Taking the view that one could as well do away with the notion of a minimum capital requirement (For example, see generally, J. Armour, above n 38, 365; E. Ferran, above n 33, 318; L. Enrique & Maccc, above n 47, 1185; Easterbrook & Fischel, "Limited Liability and the Corporation" (1985) 52 University of Chicago Law Review 103, 107; Cheetins, Company Law: Theory, Structure and Operation (1997) 508, 509. See also, for example, The Law Review Committee of the US (2 ABA-ALI) above n 35. This Committee, in reviewing the Corporations Act of that jurisdiction (i.e., post 1970 RMBCA), recommended that the minimum capital requirement be dropped on the grounds that the protection sought to be achieved was illusory and the provision of such a requirement served no useful purpose.

\textsuperscript{60} Jurisdictions that have never legislated on a minimum capital requirement are Australia, South Africa, and New Zealand. Currently, those who have abandoned it are Canada and the U.S. This does not mean that companies in these jurisdictions do not have ‘own funds’, whether share capital or other provisions, but the ‘capital’ itself used as a criterion for applying specific rules.

\textsuperscript{61} To this effect, see the US cases of, Stewart v Gould, 8 Wash 367 (1894); Saranac & Lake Placid v Arnold, 167 N.Y. 368 (1901).

\textsuperscript{62} Refer to, B. Manning and J. J. Hanks, Legal Capital (3rd ed. 1990) 176-92. Certainly, sophisticated lenders would not base a loan to a corporation on whether the minimum capital has been paid in to commencing business. In the situation of the one man corporation with limited liability, for example, since the shareholder may be the sole manager and beneficiary of the corporation and in exclusive control which is not subject to any external supervision, it is highly questionable as to whether creditors will be afforded adequate protection by restricting their claims initially to the minimum paid in capital or, even to the corporation’s assets. The shareholder in this scenario arguably has ample opportunity to apply corporate assets to his/her individual purposes, or to pledge the credit of the corporation for personal
business reputation, its net worth and its cash flow than the amount contributed by its shareholders or the amount of their statutory liability to contribute. In many cases, the minimum capital requirement has little relationship to the resources employed by the company. A company with an issued capital of $2 may be quite sound in terms of net worth or cash flow. The minimum paid in capital it may also be argued is not a means of protecting creditors because it is so easily avoided in the sense that, it would be difficult if not impossible to prevent a company, once formed worth a statutory minimum of cash, from returning the cash to the promoters either in exchange for assets such as goodwill, or, by way of a loan or, in some other way.

6.4.2. Capital Maintenance Doctrine is not a Capital Adequacy Requirement

The recapitalized or liquidate rules are undeniably much more effective at protecting creditors than the minimum capital requirement, at least so long as such rules are easily enforceable. However, to assume that these rules are analogous to a capital adequacy requirement would mean that the capital maintenance doctrine is a capital adequacy requirement. Some law and economic commentators have critically evaluated the capital maintenance doctrine from a ‘capital adequacy’ and ‘risk capital’ perspective.

63 The C&SLRC, above n 56 paras 147-149 pointed to the impracticability of introducing a requirement of minimum paid up capital. This Committee took the view that creditors cannot rely on the minimum paid in capital in the sense that, they do not look to it to determine whether the corporation has a reasonable chance of being able to pay its obligations as they become due.

64 Jenkins Report, above n 21.

65 The meaning or usage of the phrase ‘capital adequacy’ has not arisen for determination by the courts. Some commentators argue that the payment of a minimum capital required by statute does create a presumption of adequate capitalization: See, for example, the legislative reasons for imposing of s 142 of 1983 Company’s Act (UK) above n 38, 15 and accompanying text.

66 Because the Second Directive does not require a company to maintain its initial capital in the face of losses during the life of the company, those who become creditors after the company has formed are unable to rely on initial minimum capital requirements for protection. Thus, they must protect themselves in some other way.

67 Lawyer-economists who argue that the minimum paid in capital requirement cannot be likened to a capital adequacy standard include generally; International Organization of Securities Commission (IOSCO); <http://www.iosco.org/publicdownloads/pdf/IOSCOPDF06.PDF> at 1989; J. Armour, above n 47, 355; B. Manning & J. J. Hanks, Jr. Legal Capital 3rd (ed) (1990) 21; E. Ferran; Company Law & Corporate Finance (1999) 355; W. P. Harkney & T. Benson; “Shareholders Liability for Inadequate Capital” (1982) 42 University of Pennsylvania Law Review 837, 843; M. Dix; “Adequate Risk Capital: The Consideration for the Benefits of Separate Incorporation” (1958-59) 53 North West University Law Review 482. Although it will not be possible to determine exactly how much capitalization will be adequate in a given situation, several controlling principles can be gleaned from the case law dealing with inadequacy of capital. Thus, the minimum capital requirement has often been stated in dicta to apply where the shareholder’ capital was
Chapter 6

6.4. Arguments Against

Though there is no hard and fast rule as to how to determine ‘capital adequacy’, one commentator is of the opinion that capital maintenance rules do not require a company to hold a certain amount of capital against its assets.\(^{68}\) The view taken there is that the controllers of a company can invest all of the capital raised through share issues in risky assets (i.e., they can lend it to a borrower with a poor credit rating) without in any way infringing the maintenance of capital principle. Equally, it is not a breach of the capital maintenance doctrine for a company to lose its capital in improvident trading. The above commentator further contends that trading companies should not be not required to ‘hold capital’ against their assets like banks do in accordance with their prudential regulations because, to do so will affect their cost of capital and make the corporate form less attractive to small businesses and would even operate as a blanket protection in favour of all creditors.\(^{69}\)

They have argued that the minimum share capital requirement is not a capital adequacy requirement. Though there are two opposing schools as to whether the capital maintenance doctrine is a capital adequacy requirement, the absence of an acceptable definition of the terms, ‘minimum capital’ and ‘capital adequacy’ or, how it can be measured,\(^{70}\) may at times be problematic and even obscure an understanding of the question in issue.

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\(^{68}\) trifling’ or ‘purely nominal’: Anderson v Abbot, 321 US 349 (1944). In other situations, shareholders have been held liable for corporate debts where the corporation was found to have commenced business without the required minimum paid in capital: Clarendon Press Pub Co v Barksdale, 187 Cal App 2d 813 (1960). There, an individual was held personally liable for the debts of the corporation where a company conducted a newspaper business with only $500 short of the minimum amount $10,000.


\(^{70}\) Ibid. However compelling these arguments may be the view point that the capital maintenance doctrine does not require a company to hold capital against their assets may be inconsistent with s 142 of the 1985 English Companies Act and the ‘re-organized and re-capitalized’ rules (see, above notes 36-38) As earlier indicated in my previous discussion, this will depend on whether the statute governs what should happen if some of the minimum capital is no longer represented by net assets. Furthermore the position of capital adequacy for banks is in stark contrast to trading companies because; trading companies do not have the same vulnerable mix of assets and liabilities. That there is no corresponding regulation of the asset side of the balance sheet like in banks and, though the insolvency of one company may in some circumstances threaten the solvency of other companies, there is nothing close to the risk of contagion as exists in relation to banks. From the definition of ‘capital adequacy’ provided by W. Hackney et al, above n 66, 889 and, in line with the case of Auer v Frank, 227 Cal App 2d 396 (1964), where it was held that even where a company issued no shares, the corporation was not necessarily undercapitalized where its sources of funds appear adequate to its needs, then it may be wrong to take the view that a minimum capital requirement is not a capital adequacy requirement.

For a definition of ‘capital adequacy’ see, W. P. Hackney & T Benson, above n 66, 889. In its attempt to also throw some weight on how to determine capital adequacy, the Technical Committee of IOSCO (see; above note 66) provides a three prong test for determining capital adequacy. This includes the liquidity and solvency tests, the risk based requirements and the minimum capital requirement test. (According to the
It is not clear whether ‘capital adequacy’ refers either to total assets (which might be exceeded by liabilities), nor to share capital which may be an arbitrary figure. It is also less clear as to whether payment of the minimum capital required by statute would constitute a presumption of adequate capitalization. To clarify these difficulties, it is relevant to approach the issue from the point of view of the legislative purpose for imposing the minimum capital requirement but also from a financial perspective where the term ‘capital adequacy’ has, most often been used.\(^{71}\)

\(^{71}\) Cf. Robert Clark suggests that a theoretical test for inadequate capital might be developed along the lines of Justice Learned Hand’s Famous Formula for determining when a defendant in a negligence case acted as a reasonable person. The formula set forth in United States v Carol Towing Co, 159 F.2d 169,173 (2d Cir, 1947), was whether the burden \([B]\) of avoiding the risk is less than the possibility \([P]\) multiplied by the excess loss. In algebraic notation, whether \(B<P\). According to Professor Clark, \([B]\) could represent the discounted present value of the costs of an additional increment of equity capital \([L]\), the losses that would be suffered by contract and tort claimants if the corporation were to fail; \([P]\), that portion of the probability of failure would be eliminated by supplying the additional increment of equity capital: refer to, R. Clark, ‘The Duties of the Corporate Debtor to its Creditors’ (1977) 90 Harvard Law Review 546. This formula is enshrined in the law and economics literature as the centerpiece of the courts way of determining negligence. However, one commentator argues that this approach illustrates rather than cures the problems with the adequate capital test. See, for example, D. Leebron, ‘Limited Liability, Tort Victims and Creditors’ (1991) 91 Columbia Law Review 1634. Whether this formula is strong enough to demonstrate the determination of capital adequacy or, compelling enough to show how both tort and consensual creditors may be protected remains to be tested empirically. It is important note that Learned Hand was an American judge. In that jurisdiction, ‘capital’ meant ‘net assets’ and not necessarily share capital.
Chapter 6  

6.4. Arguments Against

The term ‘minimum capital’ does not seem to have any technical meaning. Neither the legislation nor the Law Reports provide any adequate explanation. If the purpose for which the law was enacted is taken into consideration, the term may take different forms. It may for example, denote merely a ‘substantial or minimal’ share capital or, even an ‘initial’ capital. Although these words are by themselves not defined, if this approach was to be the correct one, then a company may provide a substantial or initial share capital and satisfy the purpose. But, ‘minimum capital’ may also mean ‘insufficient’ or ‘inadequate capital’, which in turn may indicate that the word ‘minimum’ may not be synonymous with ‘sufficiency of capital’. Nor, does it refer to ‘adequacy of capital’.

However inelegantly the legislation may be worded, it is the writer’s view that the minimum capital imposed upon limited companies is not a capital adequacy requirement. Capital maintenance rules are about priority of creditors’ claims to those of shareholders in insolvency. Hence, they restrict transfers out of capital to shareholders but, do not require the company to maintain a specified level of net assets. The courts and creditors look to the projected cash flow of the new enterprise for the next several years based on the solvency of the company in both its equity and balance sheet sense. Although s 142 of the English Companies Act like its other European Member States legislation, tries to impose the ‘recapitalise or re-organised rules’ which is ‘nearer’ a capital adequacy requirement, the s 142 prescription applies only in extreme cases because of the very low threshold it sets.

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72 All that can be deduced from a minimum capital requirement is a ‘monetary figure’ provided by art 6 of the 2nd EC Directive which obligates member states to pass laws requiring public companies to have a minimum capital of at least £25,000.

73 This will depend on whether the statutes governs what should happen if some of the minimum capital is no longer represented by net assets.

74 The equity insolvency test is premised on the notion that a company may not reduce its capital nor makes any distribution if after giving effect hereto; the corporation would be unable to pay its debts as they become due in the usual course of its business. In this way, the directors of the company are entitled to make certain judgments as to the future course of the corporation’s business when applying this test. The current consideration will therefore be the corporation’s present liquidity, its projected future earnings and anticipated amount of debts to meet the company’s long term requirements. The balance sheet test on the other hand requires the company’s total net assets be not less than its total liabilities and total liquidation preference of preferred equity. (To this effect, see, s 45(b) of the RMBCA 1980 (US)). (See generally, W. Ralston, “The 1980 Amendments to the Financial Provisions of the MBBCA: A Positive Alternative to the New-York Statutory Approach” (1983) 47 Albany Law Review 1034-35).

75 See, the arguments relating to capital adequacy, above section 6.4.2.
This section, simply requires a public company to convene an extra ordinary meeting of the shareholders if its assets fall below one half of its legal capital, but does not mandate the taking of any particular action to deal with the situation. The section seems not to be important in practice, probably because, before it becomes operative, secured creditors will have exercised rights under their security by replacing the failing management or, the insolvent trading provisions will have required the directors to take converted action. This raises the question of whether the initial minimum capital adds anything to the rules requiring directors to take the interests of creditors into account as the company heads towards insolvency.\(^76\) Moreover, in jurisdictions like the UK and Ireland where the minimum share capital requirement is applicable only to public companies, the effect of § 142 may be weakened as a capital adequacy requirement.

There might be some limited support for those jurisdictions which adopt the recapitalise and reorganised rules. However, because these rules penalize risk taking, they may be ineffective to the effect that they prevent desirable commercial ventures, and even retard the growth of equity markets thereby, are inconsistent with the concept of limited liability.\(^77\) In a hypothetical world in which every single company abides by the recapitalize or liquidate rules, it may be argued that no company would ever become insolvent because every company would either liquidate or reorganize before that, which in turn, would mean that there would be no operational role for limited liability.\(^78\) Applying either of these rules to situations where there is a fall in the value of a company’s net assets below some pre-ordained minimum level, creates the potential for opportunistic behavior (i.e., shareholders can in fact take advantage of such provisions in dispute with other shareholders).\(^79\)

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\(^{76}\) Refer to Gower & Davies, above n 54 at 229. See also, D. D. Prentice, above n 56 who argues that, even if § 142 was to apply and an extraordinary meeting is convened, there is no obligation for anything to be done and the decision is often given to shareholders whose interests are likely to be inconsistent with those of creditors.


\(^{78}\) In certain situations, companies might still prove to be insolvent in liquidation.

A further argument that may weaken the efficacy of the recapitalize:ize rule is that majority shareholders may use it in order to get rid of financially constrained minority shareholders. For instance, if a company’s capital happens to fall to zero, shareholders who are unwilling to contribute more money to the venture will lose their shareholder status.\(^{80}\)

### 6.4.3. The Minimum Paid-in-Capital is Insignificant and Misleading

The minimum capital requirement assumes falsely that the fixed amount of a firm’s legal capital informs current and potential creditors of the resources that a firm possesses and may not freely distribute to its shareholders.\(^ {81}\) Clearly, no rule of thumb exists to determine with mathematical certainty what ‘dollar’ amount this may be for any given business although, it would not be too difficult for accountants and others to assess what capital has been required by other businesses of similar sizes and magnitude so as to reach a conclusion as to the reasonableness of the capital in a given instance.

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\(^{80}\) See, Sabine Dana-Demarel, *LE CAPITAL SOCIAL* (1989) 304-08. It can also be argued that the recapitalize:ize and reorganize rules are inappropriate because they are based on unrealistic balance sheet data. The relevant legal inquiry is whether the value of the firm’s net assets as shown on its balance sheet has fallen below the requisite statutory minimum. A company with a real economic value significantly higher than the minimum share capital amount will nonetheless have to undergo the radical restructuring that these rules require because its balance sheet does not reflect the true economic value of its assets. Consistent in the relevant accounting rules and principles, one may also concur that if liquidation is the only response to these rules, there is the likelihood for both creditors and shareholders to be prejudiced in the sense that the asserts of the company will presumably devalue in liquidation.

\(^{81}\) In the traditional view, legal capital provisions protect potential creditors against deceit by restraining companies from misrepresenting their real capital. However, the law provides general remedies against misrepresentation. This kind of rationale may be useful to explain all the specific, technical rules with the capital maintenance doctrine. However, it cannot justify the minimum capitalization requirement itself. In the real world, however, creditors (and potential creditors) care neither about these resources nor about the minimum paid in capital that are supposed to signal these resources. As some commentators puts it: “A creditor who enquires into the company’s resources before allowing it to become indebted to him does not in practice rely on the amount of the company’s capital, paid or unpaid, in assessing its creditworthiness” (R. R. Pennington, *Company Law* (7th ed 1995) 187; Company Law Review Steering Group (DTI), *Company Formation & Capital Maintenance* (1999) vi-x, available at <http://www.dti.gov.uk/clld/1843cpnl.pdf>). The concept of authorized or nominal capital can be seriously misleading in that a statement of a company’s share capital gives no indication whatsoever of the finance that a company has raised by allotting shares. Thus, the common description of many U.K Private companies as ‘£100 capital’ companies is often wrong since only a fraction of the stated capital may actually have been issued and the amount paid or payable in respect of the issued shares may be a nominal amount such as £1 (Company Law Review Steering Group, *Company Formation & Capital Maintenance* (Oct 1999) 22-24). There, a majority of the respondents in the Review Committee stated that they considered a company’s share capital to be ‘recently’ unimportant as a measure of its liability to repay creditors. This reasoning is readily explicable-the minimum capital requirement is an indication of value contributed to a company by its shareholders at some time in the past. Yet, since that value has been put into the company, it may have been dissipated, since the information they generate seems to be little use to investors. This view is consistent with those of E. Ferran, above n 50, 283; B.R. Cheffins, *Company Law: Theory, Structure and Operation* (1997) 528, 533.
Although the minimum capital requirement has been recognized by law as the price for the advantage of limited liability to shareholders, taking into consideration the net worth of the company, it may not be easy to maintain a constant equilibrium between the nominal capital of the company and the value of the assets. The value of the assets with time could depreciate or appreciate in value. Indeed, if this were to happen then the value of the assets of the company could cease to have a corresponding value to the original share capital employed. To this extent, it could be argued that any monetary pricing introduced as a signal to the market of the value of the shares in the equity of a company is almost a fiction and may not only be misleading but also meaningless.

While it is still common for companies to make provision relating to a minimum amount of net assets or to the ratio of net assets to indebtedness, the amount of share capital on its own appears to be increasingly irrelevant to a decision whether to lend to a particular company and, lenders also attach importance to cash flow and/or interest cover when deciding whether and if so how much to lend to a company. The minimum capitalisation requirement provides no meaningful protection for creditors since it is too small, insignificant and unrelated to the debt that a company may incur and to the sorts of business activities that a company may pursue. Unlike banks who usually request additional guarantees from either the company or its shareholders, in cases of compulsory liquidation, creditors rarely find solace in so small an amount of capital.

Arguably, though this amount may be considered meaningless, there is little indication that an increase in the minimum amount as suggested by some EU Member States would be problem-free. One intractable problem with an increase in the minimum capital requirement is that each company has its own unique needs, its own unique

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82 E. Ferran, Corporate Law & Corporate Finance (Great Britain: OUP, 1999) 312.
83 See, Robert Charles Clarke, Corporate Law §2.4 (1986) 77-78.
84 For example, in some of the American States that initially required a minimum capital, the figure ranges from $200-$1000 and, in most EU States though the figures vary, they are not likely to be sufficient for all types of companies. For a comparative overview of the status of minimum capitalization in some American and EU States, see for example, the tables above n 10. For a detailed pre-1970 tabular illustration of most American jurisdictions, see B.E.D., 'Statutory Minimum Capitalization Requirement' (1969) 5 Williamette Law Journal 333, 334.
entrepreneurial organization and financial characteristics. Therefore, increasing the initial share capital requirement to protect creditors would be unwise because, there can be no standard measure of the minimum equity contribution by shareholders. Yet, it may be a reasonable measure to increase the figure, depending on the nature and type of company.\(^5\)

6.4.4. Complications in the Type of Asset-Payment and the Valuation of Non-cash Shares
Apart from the question of quantum discussed above, there is also the question as to the type of asset payment to be considered effective to discharge the shareholder’s capital obligation to pay into the company treasury. What kind of asset will qualify? In reality, payment in cash or money has not posed a serious problem but, payments in kind such as services rendered, goodwill, past and future performances,\(^6\) if accepted as a medium of exchange may be problematic.

Although the Second EC Directive does not accept undertakings to perform work or supply services for the purposes of the minimum share capital requirement, it however recognizes other non cash considerations which, according to its art 10(1) as now inserted as s 108 of the Companies Act 1985 (UK), must be valued by an ‘independent expert valuer’. In this way, some commentators argue that the minimum paid in capital in the form of non cash consideration is costly in that it requires companies to pay for an independent expert report, thereby, delaying company formation.\(^7\)

\(^5\) R. C. Down, “Piercing the Corporate Veil-Do Corporations Provide Limited Personal Liability?” (1985) 53 University of Missouri Kansas City Law Review 174, 187 argued that, when ever a minimum capital requirement is higher than the amount of equity that grants an adequate rate of return for company’s shareholders, the legal capital rules have simply impeded that company from entering those markets even though the public issue of securities might be the cheapest way to raise money. The author further took the view that a high minimum capital would make it more costly for new businesses to enter into various products markets, and thereby increases the monopolistic power of incumbents.

\(^6\) The Companies Act 1985 (UK) s 99(2) and, art 7 of the 2nd EC Directive do not subscribe to the policy that work done or services rendered could discharge partly or fully the payment of a minimum capital (i.e., there is an absolute ban on limited liability companies accepting past or future consideration as adequate consideration for the allotment of shares). A disregard of these types of considerations may be taken as preventing companies to recognising value in terms of contribution to the capital—of contractual promises to perform research or innovation services for the company. This can be considered a burden on the formation of high technological companies that mainly consist of non material assets (See, E. Wymeersch, “Current Company Law Reform-Initiative in the “OECD” Countries: Challenges and Opportunities” (Working Paper Series, Financial Law Institute, The University of Gent, 2001) 43, 45.

There are varying doctrinal pronouncements as to the proper way to judge the propriety of the valuation. Most European Member States adopt the expert valuation method while, jurisdictions like Australia and the U.S where there is no minimum capital requirement, rely on the ‘directors honest estimate’ test for valuing non-cash issues. In this scenario therefore, where the minimum paid in capital is subscribed through non-cash shares, it becomes difficult to draw the line as to the ‘best approach’ to adopt for the sake of certainty and predictability.

6.4.5. Unnecessary Barrier to Incorporation
The traditional explanation that a statutory minimum capital seeks to achieve the objective of preventing the formation of frivolous incorporation has horrendous consequences for smaller companies. The imposition of the minimum paid in capital it may be argued is not desirable for small companies in the sense that since it is intended to prevent frivolous incorporation, it acts as a barrier to entry preventing small, undercapitalised companies from incorporating with limited liability.

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88 See, Chapter 7 of this study for a detail explication between the independent expert valuation and the ‘directors honest estimate’ test.
89 The 2nd EU Directive provides that contributions in kind be valued by an independent expert valuer who shall state whether the values arrived at correspond at least to the number and nominal value, or where no par value to an accountable par and/or, the premium on the shares to be issued for them (art 10). Although this approach sounds reasonable in the sense that it constitutes a safeguard against founding shareholders inflating the value of their contribution to the detriment of their creditors, this method may be problematic in that it is costly and cumbersome. Some commentators take the view that in some cases, the expert valuation adds no value to the formation process especially if the assets contributed have been fully and effectively valued at market prices (Refer to, SLIM Working Group, above n 47). This argument against the expert valuation may be strong only in a take-over bid when a listed company offers its shares in exchange for the targets shares. But in jurisdictions like Australia, which do not adopt the independent expert method for purposes of the capital maintenance doctrine, this argument may be weakened. Comparatively, the adequacy of a valuation of non cash shares is subjected to a critical scrutiny, the independent expert method seem to be stronger in terms of a nearer fair and adequate valuation than a ‘directors honest estimate’ test. See for example, the New Jersey case of See V Heppenheimer, 69 NJ. Eq 36 (1905). There, the courts held shareholders liable for the debts of the incorporation because director’s estimation for the valuation of non-cash consideration was of doubtful accuracy. However, absence empirical findings, there is no guarantee that the estimated value by an independent expert would reflect the market price.

90 O. Kahn-Freud, “Some Reflections on Company Law Reform” [1944] Modern Law Review 54, took the view that the introduction of a minimum capital requirement in the UK so as to make the formation of companies more difficult and more expensive. It would not protect creditors but would encourage the formation of large and giant companies with monopoly powers. However, one commentator counter-argues that the barrier to entry imposed by the minimum capital requirement seeks to protect creditors. (Refer to, Boden de Brandt de Brauda, “2nd EC Directive Extension to other Companies; Company Law in Europe: Recent Developments” (Working Paper, Centre for Law and Business, The University of Manchester, 1999). The current minimum figure imposed by most EU Member States constitute an unjustifiable entrance fee to the securities markets. Arguing from the perspective of the Cervaco case, the attempt of the two British residents attempt to circumvent the Danish minimum capital legislation by incorporating their business in the UK where private limited companies there could operate a business with little or no amount of an initial share capital, is illustrative of how the minimum paid in capital could act as a barrier to incorporation. The reasons being that they could not establish their company in Denmark which imposes a ‘very high’ statutory minimum paid in
Limited liability does not seem to allocate risks to small firms but rather favours sophisticated contractual creditors over smaller and involuntary ones. It is questionable if society is therefore prepared to sacrifice smaller creditors and small corporations. Whenever the minimum capital required is higher than the amount of equity that grants an adequate rate of return for any company’s shareholders, the legal capital rules have simply impeded that company from entering those markets even though a public issue of securities might be the cheapest way to raise money.\textsuperscript{91} Arguably, if minimum capital is to serve as a signaling device, it should not be used to deter other businesses from incorporation (such as small businesses), but it can be set at a low but not insignificant level. This it is believed would not set up barriers to genuine enterprise but would prevent some incorporation with limited liability that had not been properly considered.

6.4.6. Difficulties of Setting an Appropriate Level (Ceiling)

The minimum capital requirement is not only discriminatory in the sense that the 2\textsuperscript{nd} EU Directive is applicable only to public limited companies but not privately held companies,\textsuperscript{92} but, there is also an administrative problem of creating an appropriate ceiling where such a requirement operates. In attempting to figure out a ceiling, the legislative and regulatory process are likely to misestimate appropriate levels of capitalization and lag behind new market and technological data that might suggest adjustments to capitalisation requirements.\textsuperscript{93} In fact, minimum capital, it may be argued, creates an important cost of error. To the extent that legislators and regulations ‘guess wrong’ and set capitalization levels too high or too low, they will no doubt induce distortions in the market. If set too high there is the likelihood that it would impede

\textsuperscript{91} See, for example, R. C. Downs, “Piercing the Corporate Veil-Do Corporations Provide Limited Personal Liability?” (1985) 53 University of Missouri Kansas City Law Review 174, 187.

\textsuperscript{92} While the 2\textsuperscript{nd} EC Directive does not apply to private companies, many Member States have imposed laws making it applicable to both public and private companies. (Refer to the tabular illustration of the status of the minimum capital requirement, above at 10. However, in jurisdictions like the UK and Ireland, only the public traded companies (supposedly the largest companies) are subjected to this requirement. This difference leads to regulatory arbitrage which is best highlighted in the Centros case.

desirable new entries, and permit existing industries to charge monopoly prices. Therefore, the practical ground of the difficulty of setting the level appropriately for different industries and the problems of enforcement may render its efficacy questionable. The Second Directive's protections are less effective and often less restrictive in the sense that, they are not tailored to the specific financial and industrial characteristics of the company involved.

6.4.7. Conflicts of Laws

Statutes imposing a minimum capitalization requirement as a condition for commencing business are most often faced with the problem of trying to reconcile between the so called 'incorporation doctrine' and the 'seat doctrine'. The force of this argument is better illustrated by the Centros case which, according to the nature of the ruling, entails a possible conflict between rules of corporation law and those of private

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94 Understandably, if the minimum capital is to be regarded as a tool for creditor protection, the level has to be reasonably high to be of any significance, but, the appropriate level for say, a manufacturing company generally would be too much high for a service company. On the other hand, a minimum capital requirement of a modest amount which would not deter companies from entering business could do much to alert a person for whom incorporation is wholly inappropriate, to the seriousness of that course of action. It would not prevent fraud or recklessness, for which other mechanisms are needed but, it might cut down on foolishness and misapprehension, especially if used as an opportunity also to explain the implications of forming a company with limited liability to the business owners. (See, generally, J. Freedman, "Limited Liability: Large Company Theory and Small Firms" (2000) 63 Modern Law Review 337, 338). See also, ABA-ALL, MBCA ANN (1971) 206 and the case of Louis Liggett Co v Lee, 288 US 517, 557 (1933) wherein, the U.S abandoned its minimum capitalization requirement in 1970 because the statutes were incapable of setting a minimum capital level for every business. ABA-ALL, intimated that if attempts were made to set the level and it was set too low, problems would arise. On the contrary, if it was set too high, the states would defeat their own original purpose of encouraging flexibility for business growth and stimulating expanded local investments.

95 It is suggested that companies should set up an internal policy to assess the capital and its maintenance and member states need a specified control system.

96 Perhaps even more significantly, the 2nd EU Directive's protections are not tailored to the legal rules of each individual European Union Member State. The 2nd Directive's protections do not necessarily match the effectiveness of each state's bankruptcy laws and its judicial systems. Cf Rachel La Porta et al, "Law and Finance" (1998) 106 Journal of Political Economics 1113, 1145-51 (providing data showing that different countries within Europe provide a different degree of protection to creditors, and that this difference depends on the laws in place and, more broadly, on the legal and ethical environment within each country).

The 'incorporation doctrine' as used in the Centros case simply refers to a situation whereby before a company could be authorized to start business, it must meet the prescribed minimum capital requirement imposed by the law of the jurisdiction. This doctrine connects a company to the jurisdiction in which it has been incorporated, so that, the company may develop whatever activities it exercises in other states without losing its original status. According to the 'seat doctrine', it simply raises a jurisprudential question as to which law is to apply when a 'home based company' wishes to incorporate and commence business in a foreign jurisdiction.

98 Centros v Erhvervs-ør Selskabstyrelen [1999] 2 CMLR 551, 586-587. There, two Danish residents wanted to set up a closely held private company in Denmark. According to Danish law, a substantial minimum capital of a private company on incorporation was 200,000 Danish Crowns (approx. €48,000). Not able to raise this amount of minimum capital, the shareholders decided to set up the business in the UK, where there is no minimum capital requirement for private companies. (By implication therefore, a £1 would be valid for incorporation). Without starting any business activity in the UK, the shareholders applied for registration at
international law. While the incorporation theory recognizes all foreign legal entities according to the rules applicable in the state of origin, the seat doctrine refuses to recognize companies that claim to belong to another jurisdiction which is not the one in which their real seat is established. The controversy is apparent in a cross border transfer of seat and a cross border merger.

The problem is controversial as a result of the political inclinations of different states. Moreover, the issue of legal arbitrage remains a dominant factor in this debate. Whether competition between company law systems or regulatory systems in general has only negative consequences remains to be proved but is considered to be very controversial. The transfer of the seat of a company has been the subject of controversy in European Company law. Despite the express assimilation of companies in the Treaty, companies have been prevented from enjoying the same freedom of movement as natural persons. The nature of the Centros case and the debate surrounding it places the efficiency of the minimum capitalization requirement into question.

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99 The Danish Registry office in London. Held, application turned down on the grounds that as the company had not established any business in the UK, it was in fact seeking not to establish a branch, but a principal establishment and, as such, was circumventing Danish rules on the minimum capital requirement. (In other words, the court refused registration in the UK on the understanding that creditors would not have been better protected if the company had been permitted to trade in the UK). However, on appeal to the European Court of Justice (ECJ), it was decided that it was contrary to articles 43 (formerly 52) & art 48 (formerly 58) of the 'rules of freedom of establishment' of the EC Treaty to refuse to register a branch of a company formed in accordance with the law of another member state in which it has its registered office but carries on no business. In arriving at its decision, the ECJ significantly qualified its earlier decisions: R v VHM Treasury & Customs and Excise Commissioners, Ex Parte Daily Mail & General Trust [1989] QB 446; [1988] ECJ 5483. See also, D.H.M. Segers v Bestuur [1987] 2 CMLR 247 where it was difficult to ascertain if a jurisdiction where a minimum capital requirement is not applicable a company can easily incorporate and do business in another jurisdiction where it is a condition precedent for incorporation.


6.5. An Alternative Regime: A Statutory Guarantee Fund

Despite the limited attractiveness of a minimum capital requirement as an initial capital backing for voluntary creditors, the possibility remains that alternative legal reforms could achieve the same effects more effectively and at a lower cost. Suggested alternatives, such as the recapitalization and liquidation rules already analyzed, may have some merit. However, it has been argued that they may not be a suitable alternative to a statutory minimum capitalization requirement. 102

Other alternatives, such as imposing a minimum debt-to-equity ratio or a current ratio 103 or, making directors personally liable under insolvent trading laws, are also commendable. The advantage of a debt/equity ratio for example, is that it does not prescribe how much capital a company needs, but ensures that the company is not geared or leveraged to the detriment of creditors. In this way, its share capital will always bear some relation to its actual operations and need for capital. From the lender’s perspective, the debt-to-equity ratio measures the amount of available assets or ‘cushion’ available for repayment of a debt in the case of default. 104 However, the debt/equity ratio may be regarded as arbitrary and unsuitable for some companies. Though different ratios for companies in different sectors of the economy are, in theory possible, it is questionable if the ratios would be maintained throughout the company’s life.

The debt-to-equity ratio would of course be a requirement for continued corporate status, for example, limited liability status might be withdrawn once the required ratio was not achieved. 105 Accordingly, since contemporary corporate statutes are already working with solvency and liquidity as the yardstick for distribution, there is the supposition that like

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102 See, the arguments advanced by L. Enrique & J. Macey, above notes 47, 120 suggesting the recapitalize and liquidate rules as inefficient alternative.
105 See, the writers recommendations for optimum regulation of the capital maintenance doctrine and its future in chapter 8 of this thesis where the debt-to-equity ratio is elaborated upon.
the recapitalise rule, the debt/equity ratio and insolvent trading rules could be used to reinforce and strengthen the application of the capital maintenance doctrine generally but, not stand alone as an alternative to a minimum capital requirement.

Some other commentators, arguing from a law and economics point of view, have suggested that the application of a 'Liability or Mandatory insurance' might be used to mitigate risk shifting, as an alternative to a statutory minimum share capital.106 Their argument is premised on the assumption that required fixed insurance coverage or capitalization levels for companies, will be enforced by holding corporate officers personally liable for a breach of a statutory norm. However, it is argued that since the level of insurance cover would have to be fixed upon, the insurance solution has all the difficulties of a minimum capital requirement in terms of fixing the appropriate level. No single coverage level would be satisfactory across industries, firms of different sizes or, even production technologies. Some of the proponents further take the view that a panel of community volunteers might make periodic recommendations about adequate insurance levels. Arguably, this approach is not helpful in the sense that it is not only inflexible, but also will be too costly and difficult to police, possibly even more so than a minimum capital requirement, which could more easily be linked with the registration process.

It is also not clear if regulators would easily acquire the necessary information to make fine determinations of appropriate coverage levels, particularly, since the magnitude of potential tort losses would often change rapidly over time with new technological developments. If it were feasible to fix realistic coverage levels, many firms (particularly public companies) would be forced to bear unnecessary costs in an attempt to sustain and maintain sufficient coverage levels to meet all possible tort judgments.

Conversely, shareholders will not be exposed to large unbearable risks and huge damages, as they would cheaply spread their risks through the diversification potential of the securities markets themselves.  

A further practical problem with the insurance alternative is that the panel chosen in most cases may unreasonably recommend coverage levels at times on an evaluation of the books, records and business plan presented by management where the materials may be incomplete or inaccurate, leading to the possibility of evasion. The argument for mandatory insurance further assumes that appropriate insurance will be available and that effective monitoring can and, will take place. When firms carry insurance, they have the incentive to insure for amounts greater than their existing capital. The insurance company, the arguments goes becomes a contract creditor, reducing the externality that could not be addressed by limited liability or the minimum capital regime. Arguably, while insurance for companies engaged in high risk activities may allow compensation goals to be achieved; it would not be well suited for specific deterrence since the consequences of intentional wrong doing are generally uninsurable. Mandatory insurance may be workable in certain circumstances, especially in specific circumstances in reducing the extent to which certain groups of tort creditors are forced to bear the risks created by business owners, however, if monitoring is not accurate, insurance could increase rather than decrease moral hazard.

The common explanation for insurance is perhaps risk aversion. A risk adverse person may be willing to pay a known insurance premium to eliminate the possibility of a large,

107 See generally, Resource Conservation and Recovery (RCRA; 42 USCA) (1976) §6920 (West Supp 1990) (This is a U.S. Law Reform initiated to address the problems of tort creditors). This State law reform did imposed financial requirements on industries in the form of minimum asset levels and /or liability insurance coverage and, also, increased asset levels by requiring firms to deploy capital intensive technologies.


109 Other general difficulties with the insurance alternative range from problems from the impracticability of propounding schedules of adequate insurance, the theoretical and practical difficulties of enforcement, the unavailability or expense of insurance against contract liability and some types of tort liability, the immorality of quantifying possible human injury in insurance denomination (such as dollar or Euro or Pound sterling). Insurance is often said to create a moral hazard in that actors are more likely to take risks if they do not bear the ultimate costs. Thus, for example, if an enterprise is fully insured, its safety precautions may decline. Such a moral hazard is not different from the one created by limited liability. In the case of insured risks, however, it is the willing insurance provider rather than some possible unwilling third party who is the ultimate risk bearer in terms of monetary cost. Though this may be an improvement, it is not clear if the payment of higher premium for the privilege of engaging in higher risk activities will have a moderating influence on moral hazard (See generally, the references above notes 101; 104).
uncertain loss, even though the premium exceeds the expected value of the loss.\textsuperscript{110} Perhaps, by pooling unrelated risks, insurance advocates assume the risk neutral insurer can completely diversify.

It is argued that a company’s purchase of insurance seems to be inconsistent with this explanation. Whether the purchase of insurance in amounts greater than the size of the firm’s capital will reduce the incentive to engage in overly risky activities is a complex question. Before purchasing insurance, the firm’s investors have the full amount of their investment at risk. After the purchase, the investors have much less at risk. The question is who will insure the insurer since the insurance company now bears the risks of business failure caused by say, tortious conduct. If insurers assume the risk of business failure, unpaid claims of the insured firms could exceed the capital of the insurer.

The insurance alternatives in general terms will also be less compelling in relation to insurance for specific risk, such as, for example, injury to employees which are more easily quantifiable than general risks and where obviously, more policing mechanisms are available. In the U.K., for example, employees who are tort victims are protected by Compulsory Insurance legislation.\textsuperscript{111} In this respect, employees may be in a better position than creditors to monitor compliance with this requirement. This solution also enables the claims of employees against the employer’s insurance policy to take priority over other creditors in the event of insolvency.\textsuperscript{112}

Whatever the merits of the aforementioned insurance liability and risk shifting options, none of them can be regarded as the functional equivalent of a proposed ‘guarantee fund’.\textsuperscript{113} Absent any empirical evidence to the contrary, it is suggested that if creditors wish to rely on share capital as security in the satisfaction of their debts during the

\textsuperscript{110} Cheffins, above n 104, 508-10.
\textsuperscript{111} Employers Liability Compulsory Insurance Act 1958 (as amended).
\textsuperscript{112} Leebron, above n 88, 1636; Hansmann & Kraakman, above n 88, 1879-80.
\textsuperscript{113} A ‘Guarantee fund’ as distinct from either a ‘sinking fund’ or a ‘reserved fund’ is defined by the Oxford Dictionary of Current English as “a sum pledged as a contingent indemnity for loss” in, (ed) Fowler & Fowler, Concise Oxford Dictionary of Current English (1989) 442. A sinking fund is defined as moneys set aside for the purpose of sinking or wiping out a state’s or corporation’s debt by degrees (i.e., it is a fund composed of sums of money set aside periodically to provide a definite amount for a specific purpose at a certain future date)(ibid) 986. On the other hand, a ‘Sinking fund’ consists of a sum set aside out of divisible
insolvency of the company, then it is argued they will be better protected, if the
government should impose a statutory requirement requiring all companies to contribute
a percentage of their ‘capital sources’ into a guarantee fund managed and regulated by
law.\textsuperscript{114} At least, it would serve the fundamental purpose of providing a guarantee fund
which neither the minimum share capital requirement, nor the mandatory insurance failed
to attain. The fund will guarantee the payment of creditors’ claims against their company
when payment cannot be made by the company because of insolvency. How such a fund
would operate in theory and practice would depend on the efficacy of the regulatory
bodies and institutions charged with the implementation of its various rules. It is
suggested that the operation of this guarantee fund would be in accordance with similar
other compensation schemes.\textsuperscript{115} Many questions in relation to the fund’s operation may
include:

• Which companies by size and type should be required to contribute to the fund?
• How should the quantum of contribution be calculated
• What proportion of an insolvent company’s debts should be covered by the fund
• What rights should the fund have to seek an indemnity from members, directors
  and the public?

What companies should contribute, and how should assets be invested to the fund?
Both publicly-held and closely held companies limited by shares and by guarantee should
be required to make compulsory contribution to the fund. Thus, medium and large
companies with at least 20 members will be required to contribute to the fund.\textsuperscript{116} Assets
will be invested in the fund through contributions from the company, its officers,

114 This ‘guarantee fund’ approach is consistent to a limited extent to the European Union Directive No. 80/987
of October 20, 1980 (relating to the protection of employees of companies in the event of their employer’s
bankruptcy or insolvency). It is also similarly situated with a draft Bill in the Portuguese legislation in 1998
concerning the creation of a Wage Guarantee Fund to protect employees when companies become insolvent.
The draft legislation is assumed would formulate the wage guarantee that was created by Decree-Law No
50/85 of 27 February 1985. (See, European Industrial Relations Observation on-line
\wysiwyg:\//62/http://www.eiro.eurofound.ie/1998/10/InBrief/pr9810102M> at 1985

115 Sec, for example, Workers compensation, employee entitlements in a winding-up, and compensation regimes
for financial markets as found in Part 7.5 of the Corporations Act 2001 (Cth). See, for example, the
Australian General Employee Entitlements and Redundancy Scheme (GEERS) (20\textsuperscript{th} Sept 2001) at
\<http://www.workplace.gov.au/workplace/WPDisplay>>; B. Dunstan, “Protecting Employee Entitlements in

116 Cf. the Australian Labour Party’s (ALP) proposal relating to employee entitlements should their company be
wound-up at \<www.sa.alp.org.au/policy/industry/small_business.html>
members, the public and the state. The fund shall also have powers to borrow or raise money.\textsuperscript{117} While members’ liability may be limited to the amount (if any) unpaid on their shares, a company and its members could be subject to additional liability under terms of a separate contractual arrangement with the fund. The contractual arrangement with the different companies may also specify the different rates or amounts of contribution in relation to the type of business they transact.\textsuperscript{118} This additional liability may not be an exception to the principle of limited liability, but an example of the right of persons to bind themselves by separate agreement.\textsuperscript{119} Members of the fund may by a special resolution amend its constitution to increase the liability of future members.

\textbf{How should the quantum of contribution be calculated?}

The quantum of contribution would be calculated based on different indicias (methods). For example, it may be determined by reference to a percentage, based on net assets, net liabilities, payroll, and after tax profits.\textsuperscript{120} Under the payroll tax system,\textsuperscript{121} employers (the company and its directors) and employees (i.e., shareholders and other third parties) make mandatory contributions of a fraction of their ‘salaries’ up to a maximum level (or taxable wage base), to the guarantee fund. The contribution can also take the form of an after tax profit (i.e., a percentage of payroll). With this simple labour market model, the company and its members both contribute to the fund but the company and its officers, contributing the highest amount of the payroll tax, the members in the form of lower dividends. As the financial market adjusts to the economic climate, so too

\textsuperscript{117} This is consistent with the Australian National Guarantee Fund (NGF) at http://www.arsc.com.au/about/NGF_AA2.shtml. Also similar to the Irish Investor Compensation Ltd as applicable to companies limited by guarantee: http://www.irishstatutebook.ie/ZZA37Y1998512.html. See, the Irish Investor Compensation Act 1998, s 21(3) (a).

\textsuperscript{118} This approach is consistent with the Australian Law Reform Commission (ALRC) Insolvency Report (Harmer Insolvency Report (1998) and the Companies and Securities Advisory Committee, Report to the Minister for Financial Services and Regulation on Liability of Members on a Managed Investment Scheme (2000).

\textsuperscript{120} Cf the Australian Labour Party (ALP) Proposals to require medium to large companies (those with at least 20 employees) to contribute a small percentage of their payrolls to a fund which will compensate employees for their loss of entitlements should their company be wound-up insolvent at <www.acei.asn.au/text_files>

\textsuperscript{121} Refer, to, R. G. Ehrenberg and R. Smith, "Who Bears the Burden of a Payroll Tax?" in (ed), Estracher and Schwab, Foundation of Labor and Employment Law (New-York: Foundation Press, 2000) at 5. Where members have entered into a separate contractual arrangements, for additional liability, the members of the company limited by shares or guarantee may approve through a special resolution for the company to change to an unlimited company.
will the payroll tax contribution be adjusted. Under the payroll model, the employer (company) would have to make a substantial contribution approximately, $20 per member per year or 0.1-0.3% of the total wage bill. Furthermore, because the fund would only have to hold assets equivalent to a small percentage of total corporate liabilities, the percentage would have to be calculated actuarially be reference to historical corporate failure statistics.

**What proportions of insolvent company’s debts are covered?**

The proportion of insolvent company’s debts to be covered will depend on the amount of the loss suffered by creditors, or the amount of their outstanding debts. Generally, the fund would not discharge 100 percent of creditor’s debts. This will be subject to a compensation cap similar to that applicable under the employee entitlement scheme.

The fund will have to set a ceiling to the liability of an insolvent company’s debt.

**What rights should the fund have to seek indemnity?**

The fund’s rights to be indemnified will be based on the Bankruptcy Act 1966 (Cth) (as amended) and in accordance with the insolvent trading procedures under s 588G of the Corporations Act. Where the company is unable to pay its debts as a result of its insolvency and it is proven that directors of the company contravened their s 588G duties, they would be held personally liable to indemnify the fund after creditor’s debts have been discharged. The fund will also need to enter into a contractual agreement with the company and all its stakeholders to the effect that if any payments are unlawfully made to members, proceedings can be taken against such members to reimburse the fund or, the amount of any unlawful payments can be set-off from those shareholders entitlements to dividend payments.

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122 Ibid at 7.
Chapter 6  

6.5. An Alternative Regime (A Statutory Guarantee Fund)  

The strength of this alternative regime suggests that most of the weaknesses under both the minimum capitalization and insurance regimes will be eliminated. Firstly, the problem of capital inadequacy will be irrelevant in the sense that, as each company both publicly-held and closely-held is required by law to make a percentage contribution either in lump sum yearly or ‘regularly’, taking into consideration the type of company, the nature of its business and the totality of its net capital assets, there is a likelihood that the fund will have a substantial amount of funds readily available to discharge the obligations of various corporate stakeholders as they become due. This suggestion, is believed to be stronger in terms of capital sufficiency because, creditors may be comfortable in relying on it. All things being equal, the corporation has a reasonable chance of being able to pay its debts.\(^\text{125}\)

Secondly, the argument that creditors are afforded an illusory protection is avoided. Since the guarantee fund is presumed to hold a certain amount of capital against the assets of many companies, the courts and creditors (both contractual and tort claimants) in this sense, do not look to the corporation but to the projected cash flow of the fund for many years. Thirdly, the problems associated with limited liability, and the problem of a barrier to entry as existed under the old regime is also eliminated since both small and sophisticated businesses will be liable to contribute in accordance with the nature of their business. Since it will be a mandatory requirement for all companies to contribute to the guarantee fund, it would not be easy for companies to evade or circumvent this requirement.\(^\text{126}\)

\(^{125}\) The guarantee fund, it is believed, will be able to satisfy the liquidity and the solvency requirement since the fund will at all time have liquid assets which may exceed the total liabilities of companies concerned by a sufficient margin to cover the risks of the corporation’s net worth. This also eliminates the argument of ‘capital’ being ‘insufficient’, ‘meaningless’ as unrelated to the debt that a company may incur as was the case with the minimum capitalization requirement.

\(^{126}\) The percentage contribution to the fund be fixed on the basis of the company’s business. With this supposition, it is assumed companies would not be unreasonably impeded in entering the market and there would be little monopolistic powers of giant firms wanting to dominate the market and prevent small undercapitalised companies from competition. This argument may be flawed to an extent because there are significant administrative costs involved. Since the contributions to the fund would be additional (including significant costs) of using the corporate form in gaining limited personal liability, some companies would still be impeded from entering the market. However, the costs of operating the guarantee fund should be minimal when compared to that under a minimum capital requirement. Other problems envisaged with a statutory guarantee fund ranges from a complete overhaul of the corporations and securities law so as to made provision for companies to compulsorily contribute a quota of their equity shares into a guarantee fund. (Note, equity shares will be worthless when the company becomes insolvent). This process may not only be cumbersome but perhaps more costly and expensive to implement. Yet, if creditors and the public have to rely on any
Although a guarantee fund may not be a condition precedent to commencing business, it might simply be a general procedural requirement likened to registration formalities for companies. Failure to make the contribution as required should not stop companies from commencing business but should result in severe civil and criminal liability on the controllers of the company. This deterrent effect may be so effective that directors and controlling shareholders of companies will not want to be personally liable for breaches to the law.

This solution may however be questioned in the sense that if a company loses its assets in the course of its business undertaking, or as a result of improvident trading, so that its assets are less than its liabilities threatening its solvency, a percentage of its debts will be discharged by funds from the solvent companies who would need to subsidize the debts of the insolvent companies. The tendency is that, the insolvency of one company may in certain circumstances threaten the solvency of other companies. This type of practice where the solvent company subsidizes the insolvent company in paying its debts has received judicial commentary in the U.S. concerning Fraudulent Conveyance law. This was the situation in *Kiser Steel Corporation v Charles Schwab & Co.*,\(^{127}\) where s 546(e) of the above law was designed to prevent disruption in the securities industries caused by the insolvency of one commodity or security firm leading to the insolvency of the other.\(^{128}\)

The fraudulent Conveyance law aside, it may be argued that under the proposed ‘new regime’, shareholders are protected from personal liability because their risk has been shifted to the fund and therefore, it would be difficult to try to pierce the veil of the corporation for any inadequacy of capital contribution on the part of the shareholders so long as the percentage stipulated by law for each company has been satisfied.

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127 913 F.2d 846 (10th Cir 1990).
128 It is however open to doubts if a fraudulent conveyance law has any application to this proposed regime. It is difficult to imagine how a fraudulent conveyance law could be relevant to the obligation of an ‘innocent’ company to contribute to the payment of another unrelated company’s debts. Therefore, the criticism based on Fraudulent Conveyance Law that this proposal will force good efficient companies to cross subsidies bad inefficient companies is misplaced.
Creditors, whether trade or tort creditors are relieved of the burden of securing themselves. However, from the creditor perspective, the new regime may be disadvantageous to an extent because, the fund might contribute in decreasing their need to monitoring the company’s transactions. Moreover, with a change in market conditions and fluctuations in currency value, the creditors may not receive the same equivalent value to the amount initially advanced to the company. This argument does not suggest the fund will aim to pay creditors a 100 percent of the insolvent companies’ debts.\footnote{129}

Another question of crucial importance that justifies the imposition of a statutory guarantee fund as a suitable alternative regime lies in the determination of the amount of capital that is to be contributed, and the measurement of the consideration where the contribution was not in the form of cash. It was seen in the previous regime that there were difficulties of setting an appropriate level for public companies and, there was also the problem of measuring non cash shares triggering an important cost of error. Under the current proposal, it is suggested that the percentage contributed should be fixed on the basis of the company’s business, in accordance to its own unique entrepreneurial, organizational and financial characteristics.

With this understanding, it is assumed the problem of misestimating the appropriate level contribution which can cause distortion in the market will be diminished. While the question for a mathematical certainty would not arise where contributions are made in cash, it may be unreasonable to require contributions to the fund to only be in cash. Since non cash consideration is permissible in law, the optimum method for valuing such non cash contributions would be to adopt the English model of an independent expert valuator as recognizable under s 108 of the \textit{Companies Act 1985} and, under arts 7 & 8 of the Second E.U. Directive followed by, perhaps any internationally recognizable accounting standard.\footnote{130}

\footnote{129}{The value of the assets with time could depreciate or appreciate in value. Indeed, if this were to happen then the value of the assets of the company could cease to have a corresponding value to the original share capital employed.}

\footnote{130}{While the difficulties of determining the amount of contribution in cases of non cash consideration is not problem free, comparable with standard setting for a statutory minimum capital regime, it is unlikely that it will be so significant. It is also suggested that in order to recognize value especially for the formation of high technological companies whose capital consists mostly of non material assets, consideration should be given as to whether certain ‘services’ can be accepted as part of non cash shares. It is not foreseeable that future or}
6.6. Conclusion

This study has shown that the Second E.U. Directive’s minimum paid-in capital requirement provides very little protection to corporate stakeholders. The analysis suggests that the E.U should jettison its current legal capital adequacy requirements, in favour of an alternative regime requiring states to impose a statutory guarantee fund. Historically, while the notion of a minimum capital requirement was part of the price paid for limited liability, this trade off is largely obsolete in an environment where limited liability has come to be seen as a right rather than a privilege.\(^{131}\)

It is submitted that while the minimum capitalization requirement is not innocuous, it is of doubtful significance with regard to its original purpose and, its continued existence may even be detrimental to the development of the modern corporation and healthy financial markets. To make the capital maintenance rationale of effectively protecting creditors stronger, the best option to overcome this somewhat anachronistic statutory minimum capital requirement, is to review the law. Imposing a mandatory requirement on all companies to contribute a proportion of their assets to a statutory guarantee fund which will function as a full security and guarantee to both voluntary and involuntary creditors, in the event of the insolvency of a company when it is unable to meet its obligations would effectively protect creditors. It is confidently expected that with a repeal of the minimum paid in capital requirement, another fiction which has outlived its ‘usefulness’ and serves only to obscure the real nature of corporate share capital, will have been suppressed. While future company law reform should give serious consideration to this proposal, a critical inquiry into the statutory guarantee fund does not reveal any weaknesses which require drastic statutory ramifications.

\(^{131}\) past consideration be accepted because this would be resiled under the law of contract as an inadequate consideration. While this alternative measure is being reinforced by Investment Exchange Listing Rules, it is to be noted that there is definitely no objective standard to measure non cash shares although, an independent expert method would produce results nearer to an approximation in value.

CHAPTER SEVEN
ADEQUACY OF CONSIDERATION FOR THE ISSUE OF SHARES

7.1. Introduction

The general concept of consideration\(^1\) for the issue of shares is concerned with rules governing payment for shares. A subscriber for a share in a limited liability company is normally required to pay for its agreed issue price on allotment, or part of the issue price on allotment with the balance being either subject to call pursuant to its constitution, or payable by installment at specified times. The adequacy of the consideration is concerned with the capital maintenance doctrine in the sense that, creditors dealing with a company should know that the share capital provided by shareholders is fully paid and will remain in the company. It provides creditors with information about the value of the assets contributed by the shareholders to the company which might be relevant to lending decisions.

Would be creditors may view a company’s public documents and be misled if assets representing the share capital were never actually contributed to the company. In economic terms, these rules on consideration for shares might be understood as a response to problems of information asymmetry in corporate credit markets.\(^2\) They publicise to investors the value of the shares that shareholders put into the company and seek to ensure that this information is truthful.\(^3\) The regulation of the consideration for share issues is intended to protect creditors and shareholders against companies accepting

\(^1\) Consideration may be understood as a body of technical legal rules used under rules of evidence, laws of contracts and corporations, to make bargains of a wide variety either legally binding or not binding at all. (For a detailed history of 'consideration' in modern law, see, K.O. Shatwell, "The Doctrine of Consideration in Modern Law" (1954) 1 Syd LR 289). Sir Frederick Pollock defined consideration in the following language which was adopted by the House of Lords in Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd [1915]AC 847, 855:

"An act or forbearance of one party, or the promise thereof, is the price for which the promise of the other is bought; and the promise thus given for value is enforceable."


\(^3\) Ibid. This commentator posited that two observations can be made about the above rationale on the rule for the consideration for shares. Firstly, the mechanisms applied under the rule on consideration can obviously only assists consensual creditors. Secondly, the rationale suffers from internal weakness—the case with which the rules may be side-stepped by private companies through the use of non cash considerations. But, note that ‘expert valuation rules’ and ‘good faith rules’ may at least be seen as a means of plugging that gap.
consideration that is in fact worth less than the issue price of the shares. When shares are issued for cash, there is little question as to the validity and adequacy of the consideration because, the money amount measures the adequacy of the consideration. But an issue of shares on the basis that the issue price is to be credited as paid up by reference to the value of some non-cash consideration leaves open the question of the sufficiency of that consideration. This chapter aims to re-examine some of the policy issues underpinning the regulation of the adequacy of the consideration for shares in Anglo-Australian law especially, the policy problems with non-cash consideration. It argues that the current Australian approach for non-cash share issue is far from efficient and suggests that Australia adopt a contemporary ‘expert valuation’ for non-cash consideration for shares.

Section 7.2 traces the history of the requirement of accurate consideration in Anglo-Australian jurisdictions. The side by side analysis of the legislative history in England and Australia demonstrates how both jurisdictions originally regarded the concept of capital, the par value regime, no discount share issue and the share premium account as important in shaping the maintenance of capital and creditor protection. It will further illustrate how in subsequent years, while the UK still retains the above principles, Australia has abandoned them entirely in favour of a no par value regime.

Section 7.3 evaluates some policy problems relating to cross payments. It shows that though Australia has taken a different approach with regards to no discount share issues, share premium account and par value for shares, subscribers for shares are still required to provide full value for issue price and the failure to do so, creates a specialty debt. This section will also aim at demonstrating problems and difficulties of the specialty debt status. The section further demonstrates whether a subscriber for shares could discharge or extinguish its liability to the company by cross payments and set-off which is more apparent in the UK which still retains the par value regime. Another objective in this section will be to use case and statutory law in evaluating the relevance or irrelevance of past and future consideration for shares. The last section provides an optimum way by which ‘non cash consideration’ may be valued and regulated.
7.2. Legislative History

7.2.1. English History

7.2.1.1 Share Premiums

When ever shares are issued for more than their nominal or par value, the difference or excess between the issue price and their par value represents what is usually referred to as a premium. English legislation did not deal with share premiums nor were they treated as part of the share capital until 1948. However, because the determination of a share premium was left at the discretion of the courts, there has been a startling diversity of opinions produced. As early as Brander v Brander, it was decided that where profits are applied in paying up the issue price of shares there is an accretion to the capital.

But in Bouch v Sproule, the courts took the view that a company cannot both distribute profits in the form of money and capitalise them. There, a principle was laid down to the effect that, a company was required to set aside a reserve fund out of the profits of the concern, for meeting contingencies or for equalising dividends and it was left to the company to determine whether profits reserved and temporarily devoted to a capital purpose should be distributed as dividend or permanently added to its capital. Bouch was applied in Re Armitage, Armitage v Garnett. There, although the court was divided in its views, with some of the judges arguing that such excess be treated as profits (income) available for distribution, others posited that the profits should be treated as capital of the company. In Down v Gaumont-British Picture, the courts seems to have reversed some of the earlier decisions by deciding that, there was no principle of law which prevented a company from paying dividends out of assets representing premiums.

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4 [1799] 4 Ves 800. See also Irving v Houstoun [4 Paton, Sc App 521]; Re Hopkins Trustees [1874] LR 18 Eq 696.
5 [(1887) 12 App Cas 385 at 404 per Lords Watson and Bramwell.
6 [1893] 3 Ch 377. Refer also to, Mountain v Bates [1928] Ch 682, where an excess over a company’s balance sheet was carried to a ‘suspense account’ and distributed to members as cash bonuses. This was considered to be an income and not capital. Henry Johnston J opined that the cash bonuses was a distribution of profits made by the company and was to be treated as income. He put it this way:

   "The excess of capital remained an uncapitalised surplus available for distribution, either as dividend or bonus on the shares, or as a special division of an ascertained profit not from the trading of the company, but from a fortunate appreciation in value of some or other of its capital assets" [emphasis added].

In Hill v Permanent Trustee [1930] AC 720; the courts decided that any distribution of money whether called dividend or bonuses or any other name, can only be made by way of dividend profits.

7 [1937]Ch 402. There, a company which had made large trading losses, wished to use reserves partly arising from share premiums in order to pay a dividend on its cumulative preference shares. It is important to note that all of the above listed cases considered whether dividends can be paid out of premiums.
received on the issue of shares. The courts took the view that a premium was not part of the capital paid up but that, it was a reserve fund and consequently available for dividends. In 1946, the Cohen Committee considered the Drown & previous cases as poorly decided. The Committee suggested that a share premium is in essence share capital, and that it was undesirable to distribute such capital by way of dividends. The Cohen Committee recommended that in the cases of the issue of shares at a premium, these premiums should be carried to a share premium account, which was distributable only in accordance to the procedures for a reduction of capital, and that a section be added to the Companies Act whereby, the share premium account were treated as if it was paid up share capital. These recommendations were adopted and inserted as s 56 of the Companies Act 1948. This section in effect created a share premium account and gave it the status of quasi share capital to be only debited for particular purposes.

Section 56 further extended the conception of share premium beyond the cash transactions as recommended by the Cohen Report and some of the old cases, to include transactions for a consideration other than cash. This new legislative stricture was first applied in Henry Head & Co Ltd v Ropner Holdings Ltd. There, a holding company acquired two companies by means of a share-for-share exchange. The actual value of the shares acquired was much greater than the nominal value of the shares issued as

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8 The reasoning for the view that share premiums were not part of the share capital of the company was based on the argument that since par value was the nominal value of each share, any value of the issued shares above the par value was not considered to be part of the share capital.
10 Ibid.
11 (11 & 12 Geo 6 c 38). In practical terms, this was the first legislative undertaking under English law to adequately address the determination of a share premium. In effect, s 56 was to remedy the vice or mischief in the Drown case that although premiums were in essence capital, companies treated them as income. s 56 provides: Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called the share premium account and the provisions of this Act relating to the reduction of capital shall, except as provided in this section, apply as if the share premium account were paid up share capital of the company.
12 Section 56 in effect, took the share premium account out of the category of divisible profits and prevented it from being distributed by way of dividend; making inapplicable, the ratio decidendi in the Drown and previous cases. [1952] 1 Ch 124. Refer, also to, Re Duff's Settlement [1951] Ch 923 CA. These cases concerned an issue of shares by one company in exchange for the transfer of it to all the shares in another company. The court held that the excess of £5m be carried to a share premium account and to be treated as paid up capital of the company. On the arguments for the desirability of share premium generally, see for example, Horsey, ‘Share Values and Premiums’ (1951) 67 LQR 522, 523; Notes, ‘Why not Distribute Share Premiums?’ [April 1981] Accountancy 42, 42; C. Napier & C. Nok, ‘Premiums and Pre-Acquisition Profits: The Legal and Accounting Professions & Business Combinations’ (1991) 54 MLR 810;
consideration and the directors of the holding company got expert advice that they had to account for this excess by crediting it to a share premium account. This advice was upheld by the courts. The excess amount was considered to be part of the distributable profits which the company could return to the shareholders as dividends.13

The Jenkins Committee in 1962 suggested the amendment of s 56 on the ground that, there was no reason why the section should distinguished between the excess value received by a company on a cash issue and the excess value received on a transaction for a consideration other than cash. They recommended that s 56 provide in the future that a share premium arises whenever a company receives value in consideration for and in excess of the amount credited in exchange as paid up however the transaction is carried out.14 The adoption of the above recommendations resulted in the enactment of the Companies Act 1980, ss 20-2215 allowing a method of valuation of non-cash premiums. The difficulties earlier encountered under s 56 as to the nature of share premium in circumstances of mergers and acquisitions and coupled with problems of translating the 1980 Act, lead to the decision in Shearer v Bercaín.16

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13 [1952] 1 Ch 124 per Hamman J.
14 Jenkins Committee, Company Law Committee Report ("Jenkins Report"), Cmnd 1749 (1962) para 162 at 59. In their report, they further recommended that s 56(2) (a-b) requiring a share premium account to apply without leave of court to write-off expenses, and the provision on premiums payable on redemption of any redeemable preference shares be amended to prohibit the application of such account in writing-off expenses and other payments since these circumstances represent part of the ordinary expenses of borrowing (para 163). Furthermore, Jenkins Committee suggested that the rules for establishing the share premium account be modified where an acquiring company intends to treat part of the pre-acquisition profits of a subsidiary as a reserve available for distribution to its own members and, also that, the law on the valuation of non-cash premium which was conspicuously absent under s 56 be clarified.
15 Section 20(1) is to effect that, shares issued by a company and any share premium agreed to be paid in respect of them, had to be paid up in money or money’s worth (including goodwill and know-how). According to s 20(2), public companies may not accept in payment for shares or a share premium an undertaking by a person to do work or perform services for the company or to procure another person to do so. Section 22(1) sets out the general rule that a public company must not allot a share unless at least one quarter of its par value and the whole of the premium has been paid.
16 [1980] 3 All ER 295. Before Companies Act 1980 and the decision arrived at in Shearer case, it was unclear under s 56 of 1948 Act whether a company had to create a share premium account when ever it issued shares for non-cash consideration which was more valuable than the nominal value of the issued shares. Thus, in Henry Head case & in Lowry (Inspector of Taxes) v Consolidated African Selection Trust Ltd [1940] AC 648 HL, the directors were advised by the courts to account for the excess value by crediting it to a share premium account. Warton J submitted that, it was the prima facie duty of directors to obtain the best possible price for the shares. The arguments on which such practice was based were finally considered by the court in Shearer. There, it was held
Chapter 7  7.2. Legislative History: Share Premium (U.K.)

There it was decided that a company which acquired shares in another company in exchange for shares issued at a premium, was obliged to create a share premium account. As to the unresolved question of a share premium for the purposes of a merger and amalgamation, under s 56 & under the internationally accepted accounting standards, it was decided that investments in a subsidiary should be recorded in holding companies’ balance sheets at the fair value rather than the nominal value of shares issued and that, any excess be credited to a share premium account.

The problems created by Shearer, were resolved by sections 36-45 of the Companies Act 1981. These provisions, together with their successors, sections 130-134 of the Companies Act 1985 allowed companies some relief from the strict application of s 56 in special circumstances of mergers and of reconstructions within corporate groups. They also set out circumstances in which either a share premium account was not required or only a limited amount need be transferred to such an account.

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17 It should be noted that before the 1980 Act, in 1971, the Accounting Standards Committee of the UK & Ireland published an Exposure Draft: “Accounting for Acquisitions and Mergers” (EDS) in which it recommended that according to the Internationally Accepted Accounting Practice, for purposes of mergers and amalgamation, the determination of share premium be subjected to the pooling of interests’ method. Comments received on the Draft, suggested that the method might be contrary to s 56 of the 1948 Act. In 1982, after Companies Acts 1980/1981 were enacted and after the decision in Shearer v Berclain [1980] 3 All ER 295 has been adjudicated as we shall come to see, a further Exposure Draft (ED31) was issued. However, the position of s 56 and the Accounting method remained unsolved until Shearer was decided. See generally, Wyld, “Merger Accounting—Legally Dead, But will it Lie Down?” [August 1980]Accountancy 49; Accounting Standard Steering Committee ("ASSC"), Acquisition and Mergers, [Exposure Draft] (1971)3 Accountancy 4, paras 3, 25.

18 The case of Shearer was applied but modified in Stanton v Dryston Commercial Investments Co [1983] AC 501. The issue there was a tax question concerning the amount or value of the consideration given by a company which had issued its own shares in exchange for a parcel of investments. It was held the value of the consideration given by the company was the contract price/share multiplied by the number of shares issued. The Stanton case greatly modifies the principle enunciated by Lord Greene and in the Shearer case of the ‘directors honest estimate test’ by making it clear that there was no need to inquire any ‘true value’ of the assets acquired so long as the value was settled under contract. In effect, this case resulted in 1981 Act being amended by the 1985 Act subjecting any non-cash premium or other non cash consideration to an independent valuer.

19 See similar provisions under s 6 of the New Zealand Finance Act (No2) 1981.

20 Ch III of Part V of the 1985. Section 130(1) states that where shares are issued at a premium the amount of the premium must be transferred to the share premium account, which is treated with minor exceptions (i.e., for mergers and acquisitions) as issued capital of the company. While this settles the long unresolved question as to the status of a share premium, the rules relating to share premium, disappears under a ‘no par’ value shares regime. In this situation, it would be necessary to put in place alternative safeguards in respect of sums raised through share issues.

21 It has not always been clear what s 130 requires to be included in the share premium account. Relief is however obtained from the obligation to transfer amounts to the share premium account as is currently provided 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 (s 131), and where shares are issued at a premium as consideration for the transfer of assets in the context of a group reconstruction(s 132).
7.2. Legislative History: No Discount Shares (U.K.)

7.2.1.2. Discount Share Issues

Issuing share at a discount arises in situations where shares are acquired on the basis that the subscriber's liability is less than their full par value. Whether a company limited by shares could issue its shares at a discount was initially unclear. In *Re Gold Co* 22 and in *Spargo's case* 23, the courts held that according to ss 56 and 60 of the *Companies Clauses Consolidation Act 1845*, 24 companies could issue their shares at a discount. However, ss 8 & 38 of the *Companies Act 1862* were enacted so as to repeal the 1845 Act. The 1862 Act provided that a company limited by shares had no power to issue shares at a discount so as to render the shareholders liable for a smaller sum than that fixed for the value of the shares by the memorandum of association. The effect was to preclude companies from issuing shares as fully paid up in respect of the payment of a sum less than the nominal amount of the share. 25

The 1862 Act notwithstanding, in *Re Plaskynaston Tube Co* 26 and in *Re Ince Hall Rolling Mills Co*, 27 Chitty J held that a company limited by shares was not prohibited by law from issuing shares at a discount because the 1862 Act did not legislate on the mode of payment for shares and further because a contract made by a company to issue shares at a discount was valid if registered. The problem of construction of the 1862 Act and the fact that it did not legislate on the mode of payment for shares, lead to the passing of s 25 of the *Companies Act 1867* 28.

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22 [1872] 11 Ch D 701.
23 *Re Harmony and Montague Tin and Copper Mining Co (Spargo's case)* (1873) LR 8 Ch App 407
24 (8 & 9 Vict c 118).
25 Sections 7, 8 & 12 of the 1862 Act provides: “A company limited by shares has no power to issue shares at a discount so as to render the shareholders liable for a smaller sum than that fixed for the value of the shares by the memorandum of association and, such issue will be invalid”.
26 (1883) 23 Ch D 548
27 (1883) 23 Ch D 542. These two cases were decided simultaneously, Chitty J relying partly on the *Companies Clauses Act 1863* (26 & 27 Vict c 118) which though in its s 21 carried forward the prohibitory language of the 1862 Act, argued that both the 1862 and 1863 Acts did not prevent a company issuing its shares at a discount. His honour further opined that even if there was such a prohibition, it was repealed by s 5 of the *Companies Clauses Act 1869* (32 & 33 Vict c 48). From the 1862 Act perspective, Chitty J contended that Table A arts 26 and 27 made no reference as to the issue of new shares, thereby, permitting companies to issue their shares at a discount. But also see the views taken by Buckley QC and Woods who argued that the decision taken by Chitty J was contrary to the principles laid down in *Trevor*. They further contended that s 25 of the 1867 Act cannot be relied upon because that section was intended to apply to shares issued for a good consideration, though not in money. The y commented that: “a payment of 2s can never be a good consideration for the issue of a £1 share”.
28 (30 & 31 Vict c 131). It is to be noted that the prominent mischief which was to be dealt with by s 25 of the 1867 Act was the question of the issue for the payment of the consideration for the shares (i.e., the mode of payment) which was not adequately addressed by the 1862 Act. But there was some ambiguity in the language of s 25 itself.
Section 25 provided:

Every share in any company shall be deemed and taken to have been issued and to be held subject to the payment of the whole amount thereof in cash unless the same shall have been otherwise determined by a contract duly made in writing and filed with the Registrar of Joint Stock Companies at or before the issue of such shares.

This provision regulated the mode of payment for shares and recognized a power in the company to accept a partial payment, provided there was a contract duly executed by the parties. In *Re Almada & Tirito Co*, the decisions arrived at *In Re Plaskynsaston* and in *Re Hall* were overruled with the courts unanimously decided that, a company limited by shares under the 1862 and 1867 Acts, had no power whatsoever, to issue shares at a discount. In reconciling the *Companies Acts 1862 and 1867*, and to fully address the mixed views expressed in previous cases, (and in particular the uncertainty as to whether a company had power to pay an underwriting commission), the House of Lords in *Ooregum Gold Mining Co of India v Roper*, laid down a mandatory rule that there was no power under the Companies Acts for a company to issue shares as fully

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29 (1888) 38 Ch D 415 at 423.
30 [1892] AC 125. There, the House of Lords held that where a commission was paid out of capital, the issue was to be regarded as an issue at a discount and therefore ultra vires the company. As Lord Halsbury LC cogently put it:

I think, with Fry LJ in the *Almada & Tirito* case, that the question which your Lordships have to solve is one which may be answered by reference to an inquiry: what is the nature of an agreement to take a share in a limited company? ... That question may be answered by saying that it is an agreement to become liable to pay to the company the amount for which the share has been created. That agreement is one which the company itself has no authority to alter or qualify, and I am therefore of opinion that, treating the question as unaffected by the Act of 1867, the company were prohibited by law, upon the principle laid down in *Ashbury Railway Co v Riche* [1875] LR 7 HL 653, from doing that which is compendiously described as issuing shares at a discount.

Arguably, while it is an intrinsic part of any underwriting transaction that the underwriter in consideration of his promise to underwrite for the company, is to be paid a commission it is less clear under ‘public policy’ whether such commission and ‘brokerage fees’ can be considered payments at a discount and therefore, ultra vires. In *Metropolitan Coal Consumers Association v Scrimgeour* [1895] 2 QB 604 the court held in the negative although, in *Welman v Saffery* [1897] AC 299, it was ultra vires for a limited company to issue shares at a discount or even by way of bonus. Refer also, to the case of, *Mostly v Koffyfontein Mines Ltd* [1904] 2 Ch 108 at 117 where the Court of Appeal prevented the issue of convertible debentures at a discount upon the argument that it could open up the way to abuse. There can be apparent difficulties in applying the ‘no discount rule’ in connection to convertible securities. The situation may be different from that where debentures issued at a discount are immediately convertible into fully paid shares having a par value equal to the par value of the debentures. So interpreted, it can be argued that the decision in *Mostly* does not prevent the issue of convertible securities at a discount where the conversion right is not immediately exercisable. There can be no hard and fast rule governing the length of time that would have to elapse between the issue of the debentures and permitted exercise of the conversion rights. It would presumably depend on whether there is a genuine reason for the discount.
paid up for a money consideration that was less than the nominal value but, that shares may be lawfully paid-up, for a consideration which the company has agreed to accept in representing in money’s worth the nominal value of the shares. The Companies Act 1862 & 1867 and, the principle laid down in Ooregum Gold Mining were repeated with limited exceptions in s 47 of the Companies Act 1929 and s 57 of the Companies Act 1948. In 1977, the Second EC Directive in art 8(2) suggested that a limited exception be applied to the discount rule whereby a company could pay commissions and discounts up to a statutory limit. This was implemented as an exception to the rule and inserted as s 21 of the Companies Act 1981 permitting a company to pay commissions and discounts up to 10% subject to certain safeguards. Section 21(4) was also enacted so as to repeal the former statutory power for the court to approve the issue of shares at a discount. The principle enunciated in the Ooregum case was codified by ss 99-116 of the 1985 Act.

Section 100 for example, stated that the ‘no discount rule’ could not be evaded by issuing convertible debentures at a discount which are capable of being immediately converted to ordinary shares. Although the current law provides for statutory provisions governing the law on payment of shares, the statute does not deal with situations relating to share price discount on a single share. Section 100 covers only situations relating to the allotment of more than one share (“a company’s shares shall not be allotted at a discount…”). What happens where only one share is allotted at a discount? The law is silent. It can be suggested that since an issued share is part of the share capital, the directors of the company, as persons who manage assets of the company, have unquestionable fiduciary duties towards the company they direct.

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31 This provision which featured in earlier statutes has been re-enacted as sections 97-98 of the 1985 Companies Act.
32 In effect, s 100(1) is that shares may not be allotted at a discount to their nominal (par) value. Cf Mosely v Koffyfontein Mines Ltd [1904] 2 Ch 108. It is to be noted that s 100 continued to prohibit the issue of shares at a discount by providing that, where shares are issued in contravention of the prohibition, the allottee has to pay the amount of the discount together with interest. Section 102 prohibits a public company from allotting shares as fully or partly paid-up (as to their nominal value or any premium on them) otherwise than in cash if the consideration for the allotment is or includes an undertaking which is to be, or may be, performed more than five years after the allotment. According to s 103, all non cash issues for public companies must be subject to an independent expert valuation except for mergers and acquisitions. Directors who authorize the allotment of shares at a discount may be liable to the company for breach of fiduciary duties: Hirsch v Simp [1984] AC 651.
On this basis, they can be held liable for breach of fiduciary duties if they allot one share at a discount. The desire to avoid dilution of shareholders’ claims and thus, to preserve shareholder equality was thought to explain the law’s negative view of discounts. Despite the limited exceptions on the ‘no discount rule’, a rule precluding issues at a discount to par value may be dysfunctional because it allows shares to be issued at a discount to market value if the issue price exceeds par but does not allow shares to be issued at market value if that value is less than par. If the rules are predicated on protecting creditors, they may make them worse off if they make it harder for a company to raise new equity. A further deficiency in the above rule is recognized where the consideration for the shares is not in cash since the courts have refused to value the consideration. It therefore follows that the prohibition on issues at a discount could be trivialized. Moreover, if a company had given itself power in its constitution to make a share split (a share split divides a share of given par value of say, £1 into shares of a smaller value say, four shares of 25 cents each), then, if the market value was 4 cents, the issue would not be prohibited.

7.2.1.3. Non Cash Consideration

Under sections 7 & 12 of the Companies Act 1862, shares in a limited company may be lawfully issued as fully paid up for a consideration which the company has agreed to accept as representing in money’s worth the nominal value of the shares. Thus, payment for shares need not be in cash; payment might be in goods or services (i.e., in money’s worth). Thus, in Pellat’s case\(^{35}\) and in Baglan Hall Colliery,\(^{36}\) the courts decided that a man who agrees to take shares is not bound to pay for them in money (cash); he may pay for such in money’s worth (including goodwill, services, labour or property). The 1862 Act was flawed in the sense that although it stipulated that shares could be fully paid up

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\(^{34}\) See, Ibid.

\(^{35}\) Re Richmond Hill Hotel Co (Pellat’s case) (1867) 2 Ch App 527.

\(^{36}\) In Re Baglan Hall Colliery Co (1870) 2 Ch App 346. See also Anderson Case (1877) 7 Ch D 75. Refer also to Oregum Gold Mining where it was established that the courts would doubtless refuse effect of a colourable transaction where the shares were issued at a discount, but ruled that, so long as the company honestly regards the consideration given as fairly representing the nominal value of the shares in cash, its estimate ought not to be critically examined. (Per Lord Watson at 136).
in money’s or money’s worth, it did not adequately address the mode of payment for shares, exposing the law to considerable abuse.\textsuperscript{37} The 1862 Act was amended by s 25 of the 1867 Act\textsuperscript{38} providing a mode for payment and by rendering transactions such as in Pellatt’s case and Re Baglan case invalid. Both the Companies Acts 1862 and 1867 and some of the early authorities seem not to have expressly or impliedly alluded to whether past or future consideration could be considered good consideration. These issues were first addressed in Re Casey’s Patent\textsuperscript{39} where the courts held that future consideration was to be taken as good consideration. But, in Re Eddystone Marine Insurance Co\textsuperscript{40} Wright J reversed Re Casey Patent, holding that past consideration in the nature of past services cannot be any good consideration unless the allotment agreement was under seal.

The issue as to future or past consideration was finally made mandatory in Re Wragg Ltd\textsuperscript{41}. There, the court overruled the decision in Re Eddystone. It was held that, although a company cannot issue shares at a discount, it can, provided the contract is duly registered, buy property at any price it thinks fit. The court considered that the company may pay for

\textsuperscript{37} Some of the abuses evident under the 1862 Act included for example, circumstances in which shares were allotted as fully paid up in consideration of services rendered which, on various grounds, enabled the company to go before the world under the false pretences that the shares were taken on the footing of the shareholders paying the amount in cash: See for example Re Baglan’s case (ibid); Drummond’s case [1869] LR 4 Ch 772.

\textsuperscript{38} Section 25 provides:
Every share in any company shall be deemed and taken to have been issued and to be held subject to the payment of the whole amount thereof in cash, unless the same shall have been otherwise determined by a contract duly made in writing…
This could be literally interpreted in the sense that, shares were henceforth to be paid only in cash but that unless agreed by a contract duly registered, can such shares be considered as paid-up in money’s worth. Alternatively, the language of s 25 is that, such a contract must be one which is ‘honest’, ‘bona fide’ ‘valid and effective’ and once such a contract has been duly agreed upon in writing as the consideration, the contract cannot be defeated by allegations as to the inadequacy of the consideration. See for example Re Almada & Tiritto Co (1888) 38 Ch D 415. Arguably, the true construction of s 25 seems to be ambiguous. It intends to deal with the mode of payment and not whether the whole amount should or should not be paid in some way or the other- i.e., it does not affect the liability to pay in some shape or the other. It also applies only to bona fide contracts.

\textsuperscript{39} Re Casey’s Patent; Sterwart v Casey [1892] 1 Ch 104 at 116. There, Bowen LJ, held that the consideration must be something although it involves rendering services in the future. He opined that it is the promise to render the services which constitutes the consideration and as such, a promise to render future services if an effectual promise is certainly good consideration. He also contends that past services will support a promise and therefore good consideration.

\textsuperscript{40} [1893] 3 Ch 9. The principle laid down here is that it is ultra vires to issue shares except as against a consideration equivalent to the amount mentioned on the face of the shares. The court took the view that such past services were not real services rendered whatever, and that despite the so called contract duly signed, the shares were a mere gift.

\textsuperscript{41} [1897] 1 Ch 796 at 829. Re Wragg was influenced by authorities such as Re Almada & Tiritto; & Ooregum Gold Mining where it was ruled that so long as a company honestly regards the consideration given as fairly
such property in fully paid-up shares and that any such transaction will be valid unless it is impeached by fraud.

The value received is to be measured by the price at which the company agreed to buy the property, and the courts need not inquire into the adequacy of the consideration.\textsuperscript{42} The principle developed in Re Wragg remained in force until the Companies Act 1948. Since there were no adequate provision or detailed rule requiring valuation of shares in the previous Acts, save for the fact that any consideration which was carried on an ‘honest estimate’ by the directors for the value of the shares was considered an adequate valuation for the shares.\textsuperscript{43}

In 1976, 2\textsuperscript{nd} E.C. Company Law Directive,\textsuperscript{44} noted that the 1948 and previous Acts relating to the ‘directors’ honest valuation test’ was inadequate. The 2\textsuperscript{nd} Directive implemented procedures for the amendment of the 1948 Act with effect that future legislation be enacted in which any valuation for shares especially non-cash consideration for public companies, will be subjected to an ‘independent expert valuation’. The 2\textsuperscript{nd} Directive further took the view that companies be banned from accepting undertakings to do work or perform services as consideration for the allotment of shares.\textsuperscript{45} Subsequently, the Directive was implemented as sections 23 & 24 of the Companies Act 1980. These

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\textsuperscript{42} Similarly, in Brownlie & Ors Petitioners (1988) 6 ALT 251, decided just after Re Wragg, Darling L.J ruled: 'Where a company, in good-faith issues shares as fully paid-up in consideration of property transferred or services rendered, the court will not inquire into the value of that which was accepted by the company as an equivalent of money.

\textsuperscript{43} In a catalogue of cases, the courts have posited and held that the directors were better placed to value non-cash considerations. Refer to cases such as: Salomon v Salomon [1897] AC 22; Re Wragg, above n 35; Ovregum Gold Mining, above n 27

\textsuperscript{44} EC 2\textsuperscript{nd} Directive (1977) 77/91/EEC; OJ L26/1 articles 1, 10 & 29. Although the 2\textsuperscript{nd} Directive was focused only to public companies, they were to apply to private companies hoping to convert a public company. It is noteworthy to also pay attention to ‘SLIM’ Report, European Company Law: The Simpler Legislation for the Internal Market (SLIM) Initiative of the European Union Commission (August 2000) Financial Law Institute, Working Paper Series, University of Ghent. SLIM initially argued against the expert valuation in circumstances where for example, shares of a company are actively traded, the need for an external expert valuation upon shares being contributed to form the capital will usually serve no economic purpose. They however saw the need for such an expert valuation but suggested that, if the assets so contributed are regularly traded-especially securities traded on the market, the need for an additional valuation would diminish especially in cases of a take-over bid. SLIM proposed that, if assets have been valued in a recent financial statement of a company, there is no reason for proceeding to an additional valuation. This recommendation is yet to be given effect.

\textsuperscript{45} 2\textsuperscript{nd} Directive, Ibid, art 7, 4.
detailed rules requiring expert valuation and non cash consideration are now codified and enacted as part of ss 99-116 of the Companies Act 1985 which remains the law till present. The current Act recognizes two mandatory provisions which prohibit public companies from allotting shares for non cash consideration. The first applies an absolute ban on accepting past or future consideration as a proper consideration for the allotment of shares. In addition, public companies are also restricted with regards to accepting other types of undertaking as consideration for their shares. These forms of consideration were disallowed because the company had not come under any obligation to pay for such types of consideration. The second mandatory provision relates to the allotment of shares as fully or partly paid-up for a consideration to transfer property to the company after five years from the date of allotment (known as the ‘five-year rule’). A public company henceforth, must not allot shares unless they are paid up as to one quarter plus any premium. This however, does not apply to shares allotted pursuant to an employee share scheme.

7.2.2. Australian History

7.2.2.1. Share Premium

A line of early English authorities including Bouch v Sproule, may have influenced the State of Victoria in 1896 to take the initiative, well ahead of the UK, to legislate on the treatment of share premiums. The decision arrived at in Re Armitage in particular, resulted in the enactment of s 49 of the Companies Act 1896 (Vic).

46 There is no doubt that it was to avoid the difficulties associated with the issue of shares in return for non cash consideration that the Company’s Act 1985 introduced new provisions making an allottee of shares for non cash consideration liable in certain circumstances for the aggregate nominal value of the shares (and any premium) if there were default in compliance with the provisions regulating the issue of shares for non cash consideration (s 103).

47 Company’s Act 1985. s 99(2) provides that a public company may not accept as consideration for the issue of its shares including any premium, an undertaking to do work or perform services for the company.

48 Companies Act 1985, s 102. In accordance to arts 9.2 & 2.1 of the EC 2nd Directive, this section was inserted restricting payments of shares in a public company by any long term undertaking. Section 103(3) of the 1985 Act is analogous to s 24(2) of 1980 Act providing circumstances in which an independent expert valuation is not required. This is cases for example, where shares are allotted by a company in connection with its proposed merger with another company. (i.e., where one of the companies proposes to acquire all the assets and liabilities of the other in exchange for the issue of shares or other securities of the first company with those of the other, with or without any cash payment to the shareholder).

49 (1837) 3 App Cas 385 at 404. See also Bond & Boulton [1799] 4 Ves 806; Irving & Houston [(1895) 4 Paton, Se App 521.

50 Re Armitage, Armitage v Garnett [1893] 3 Ch 377.
Chapter 7
7.2. Legislative History: Share Premium (Australia)

It prohibited until 12 months after a company had been established, any issue of shares at a premium. In *Re Tasmanian Credits Ltd.*, a company purported to issue shares at a premium when it has not been established. The court prevented the company from issuing its shares at a premium when they have not incorporated for at least twelve months as required by s 272 of the *Companies Act 1920* (Tas). Secondly, s 49 required that money or other value received for the issue of a share beyond its par value, had to be accounted for separately from share capital in a reserved fund and could be used to pay dividends.

In 1910, s 49 was amended by the *Companies Acts 1910-1938* (Vic). While restating s 49, the new Act made an additional requirement that the premium in the reserve fund was not to be used for payment of dividends. This requirement lead to the decision in *Moore v Carreras Ltd.* There, a company declared a special capital bonus from the ‘premium reserve fund’. The court being guided by English authorities, held that ss 277 & 278 of the *Companies Act 1938* (Vic) did not prohibit a distribution of money received as premium on the issue of its shares. This would mean the premiums could be used to pay the shares up.

Being guided by the Cohen Committee’s recommendation and by s 56 of the *Companies Act 1948* (UK), and more likely by the decision in *Knowles v Ballarat Trustee*, where it was held that any payments to members in excess of the nominal capital as dividends, or as a bonus or as a distribution of assets per share, were to be treated as share capital of the

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51 Section 49 of the 1896 Act (Vic), was repeated with a similar of language in s 278 of the *Companies Act 1910* (Vic); s 278 of the *Companies Act 1915* (Vic); s 272 of the *Companies Act 1920* (Tas); ss 277 & 278 of the *Companies Act 1928* and 1938 (Vic).

52 (1931) 27 Tas LR 1.

53 The court was of the opinion that such premiums were illegal, that although the issue of the shares was not invalidated, the issue was a void consideration.

54 [1935] VLR 68 The Full Court held that premiums so received or carried to the reserve account were not share capital and were available for distribution among shareholders by way of dividends. Generally, where no fresh issue of shares for purposes of redemption is contemplated, the requirement that capital be repaid from profits may be inhibiting for an issuing company. It may be difficult for the company to find sufficient profits for both payment of dividends and redemption. Therefore, issuing shares at a premium can solve this problem. This frees the issuer from the need to find profits to repay this amount.

55 Refer to *In Re Hoare & Co Ltd* [1904] 2 Ch 208; *Re National Bank of Wales Ltd* [1899] 2 Ch 629; *Drown v Gaumont-British Picture* [1937] Ch 402.

56 (1916) 22 CLR 212. The issue in question here was applied in *Fisher v Fisher* (1917) 23 CLR 337. See also an earlier decision in *Re Woolton* [1905] VLR 599 at 605 where the same law was followed.
trust estate, the old law was replaced by s 50 of the *Companies Act 1958* (Vic). Section 50 provided that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premium on those shares had to be transferred to an account called the share premium account. This amount was to be treated as a quasi share capital which could only be reduced in accordance with the procedures for a reduction of capital.\(^{57}\) Section 50 became s 60 of the *Uniform Companies Act 1961/62*.

Like its predecessor, the difficulty of constructing s 60 as concerns the status of unpaid premiums, resulted in the decision of *Niemann v Smedley*,\(^ {58}\) where it was held that the amount (if any) unpaid on the shares, meant the amount unpaid on the nominal value of the shares. The decision arrived at in *Niemann*, lead to the amendment of s 60 which was enacted as s 119 of the *Companies Act 1981*, laying down the rules governing the valuation of premium and non-cash premium. Section 119 also permitted the share premium account to be applied in paying up in whole or in part the balance unpaid on shares previously issued to members of the company and, further permitted the section to operate in all cases of non cash considerations specifically in cases of mergers and acquisition. Section 119(2) (a-c), permitted any amount in the share premium account to cease being a quasi capital and to actually become share capital of the company. Section 119 was re-enacted as ss 190-191 of the *Corporations Law* ("CL"). The reason for making the share premium account part of the share capital was to make a company’s

\(^{57}\) Section 50 is simple a restatement of s 56 of the 1948 Act (UK). In any case, it should be recognized that even where new shares are issued at a handsome premium, existing shareholders may still face a peril of dilution. This is particularly the case where an allotment of new shares is made in exchange of an asset other than cash. The common law has always adopted an aleatory view of the assessment of the value of the consideration received for an issue of shares. Directors thus have the ability to dilute existing shareholders claims by allotting the vendor of the assets a disproportionately large stake in the capital of the company. The only constraint on such conduct (other than market constraints) are the directors fiduciary duties: *Shearer Inspector of Taxes v Bercain* [1980] 3 All ER 295, 307 where Walton J thought that except in special circumstances, “it is the obvious duty of directors to the best of their abilities to consider very carefully how few shares they can issue to achieve the desired acquisition of any particular assets”. (There are also restrictions imposed by Listing Rules which effectively give shareholders veto rights in respect of significant non-proportional share placements: ASX LR 712.

\(^{58}\) [1973] VR 769, (1971-73) CLR 40. There, it was held that the expression ‘amount unpaid’ on shares within the meaning of s 218(1) (d) of the 1961 Act, referred to the amount unpaid on the nominal value of the shares and did not include the amount unpaid on the share premium. *Niemann* was followed in *South Australian Barytes Ltd v Wood* (1976) 12 SASR 527. And, in *Vavasseur Pacific Ltd* (1977) 2 ACLR 414. But, distinguish *Niemann* with *Re Applications of the News Corporations Ltd* (1987) 70 ALR 419 where it was held that the words ‘amount paid on the shares’, was to be read as the ‘amount of capital paid on the shares’ including the premium.
Chapter 7  

7.2. Legislative History: Share Premium (Australia)

...equity accounts more comprehensible. Companies were to maintain a single account for share capital which in economic terms represented the aggregate value actually contributed by shareholders in cash or kind. From a comparative point of view, though s 119 makes reference to mergers, it is unclear if it is consistent with s 56 of the 1948 Act (UK) and the English authority in Shearer v Bercaín, concerning share premium for purposes of mergers and amalgamations. Clause 26 of Australian Accounting Standard (AAS 21) reads:

"The Pooling of Interests Method’ shall not be used in accounting for acquisitions without adequately resolving the legal position…”

In the UK for example, according to internationally accepted accounting practice, in situations of mergers and amalgamation, the ‘Pooling of Interests Method’ is considered as the appropriate method for the determination of issues at a premium.

In 1986, the Company & Securities Law Review Committee suggested that s 119 posed a problem of application and that the decision in Niemann was bad law if compared to similar provisions in jurisdictions such as the UK & NZ. They recommended the repeal of s 119(2) (b) (e) and, the amendment of s 119(2) (f) and s 120 (4).

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60 [1980] 3 All ER 295.
61 With Australia’s adoption of International Accounting Standards (IAS), it is unclear as to whether the same view would have applied. However, as will be seen shortly under the current Australia’s position to share premium, and the demise or abandonment of the share premium account, the position would have been in accordance to “IAS”.
62 Refer to The Introduction to the Internationally Accounting Standards (Nov 1983) para 29. From accounting point of view however, it was considered that premiums should be treated as capital contributions.
64 Generally, the C&SLRC recommended that s 119(2) (b)(e) be repealed because they are provisions which allow a de facto method for the reduction of capital i.e., they permit a share premium account to be applied in satisfying the unpaid liability owed to the company in respect of partly paid shares which may be at variance with the capital maintenance rule especially, with regards to the provisions against the reduction of capital in s 123(1)(a) of the 1981 Act & s 195 of the CL which recognises that, a cardinal aspect of maintenance of capital is the retention of liability to pay up partly paid shares. They further recognised that s 119(2)(f) allows a share premium account to be applied in providing for the premiums on redemption of redeemable shares, something at odds with the Cohen Committee Report and s 56 of the 1948 Act (UK) which regards or prevents the distribution of share capital by way of dividends. They recommended that s 119(2) (f) & 120 (4) be amended so as to remove the liability of a company to apply the share premium account in providing for the premium payable on redemption of debentures and for the enactment of a provision that an amount payable in cash by way of premium upon the issue of a share shall be regarded for all purposes as an amount unpaid on that shares.
These recommendations were implemented by the *Corporations Law Review Act* 1998 and consolidated by the current *Corporations Act* 2001. The effect was that since shares were no longer issued with a par value, companies can no longer receive a share premium. This resulted in the demise of the concept of a share premium under the law. Any amount standing to the credit of a company’s share premium account became part of the company’s share capital. If a company’s constitution provided for the liability of members for unpaid premiums, that liability was in the nature of a ‘specialty debt’ for the purposes of former s 180 (2). Accordingly, under the current regime, with the abandonment of par value, subscribers for shares are still required to provide full value for issue price. Failure to do so creates a specialty debt. A company, therefore, can not agree to the specialty debt being replaced with a simple contract debt.

Though s 180 has been replaced by s 140 of the current Act, the Act is silent about amounts owing to a company under its constitution being specialty debts. Interestingly, with the demise of the par value regime in Australia, it is unclear why both the share premium and the no discount rule continue to play a significant role in the English and European Member States. Perhaps the justification is that since the minimum capitalization requirement still holds firmly in those jurisdictions, this suggests the retention of both the no discount and share premium concepts. It can be argued that with the limited importance to which creditors attached to the minimum paid in capital for their protection, that justification may be questioned.

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65 C & SLRC, recommended the amendment of ss 119, 120 and 191 of the ‘CL’ to make it no longer possible for the share premium account to be applied in providing redemption premiums on redemption of redeemable preference shares (para 10). Also, that s 119 be amended so as to prohibit the application of the share premium account in writing-off expenses and commissions paid and discount allowed on any issues of debentures (para 24). Furthermore, to assimilate an unpaid premium for an allotment of shares to unpaid share capital (para 32).

67 *Corporations Act* 2001 (Ch), s 254C.


68 As to specialty debts, see, the discussion below, section 7.3. See, also, *R v Williams* [1942] 2 All ER 95 per Lord Maugham, HL.
7.2. Legislative History: No Discount Shares (Australia)

7.2.2.1. Discount Share Issue

Early English cases\(^69\) and statutes\(^70\) were inconsistent as to whether a company could issue its shares at a discount despite the fact that the Companies Acts 1862 and 1867 prevented companies from issuing their shares at a discount. When the House of Lords in Ooregum Gold Mining, finally held that there was no power under the Companies Acts authorizing companies to issue shares at a discount, Companies Act 1899 (NSW), s 55 was enacted. The House of Lords ruling was affirmed by the High Court in Gold Smith v Colonial Finance Ltd,\(^71\) resulting to the enactment of the Companies Act 1915 (Vic), s 97.\(^72\) In accordance with s 49 of the Companies Act 1958 (Vic), the previous Acts were repealed empowering a company in exceptional cases to issue shares at a discount under certain preconditions.\(^73\)

Because the value of the consideration in s 49 under the 1958 Act was unclear and, couched with other irregularities and problems,\(^74\) it was amended, leading to sections 116

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\(^69\) See, for example, Re Gold Co [1872] 11 Ch D 701; Spargo v Reeve [1873] L.R. 8 Ch App 407; Re Plaskevaston Tube & Re Ince Hall Co [1883] 23 Ch D 542, 545; Re Almada & Titter [1888] 38 Ch D 415 at 423.

\(^70\) See, Companies Clauses Consolidation Act 1845, ss 56 & 60.

\(^71\) (1909) 8 CLR 241 at 248. There, a company issued debentures at a discount and continue to trade unprofitable. The House of Lords held this was ultra vires because it was a scheme for issuing shares at a discount. See also, Bury v Pamatina (1909) 1 Ch 759.

\(^72\) Section 97 of the 1915 Act (Vic), was similarly repeated in other State Jurisdictions such as, ss 60 of the Companies Act 1934 (SA); S 58(2) of the 1962 Act (SA); S 146 (2) of the Companies Act 1936 (NSW).

\(^73\) Section 59 of the 1958 Act (Vic) was re-enacted in a 58 of the Uniform Companies Act ("UCA") which authorized the payments of commission in certain circumstances. This trend of events, contrary to the English rule, required shares to be issued at a discount if authorised by a special shareholder resolution and with the sanction of the court. Such a resolution, if duly passed, was to specify the maximum rate of the discount at which the shares were to be issued. These exceptions included circumstances for a company to be able to pay certain commissions, but prohibited the payment of all other commissions. It is noteworthy that s 49 was repealed word verbatim in s 150(1) of the Companies Act 1957 (NSW); ss 59(1) and s 64 (1) of the Companies Act 1962 (SA). It has been commented that the general purpose of the 1958 Act was to give better effect to the basic principles underlying company law relative ease of incorporation, maintenance of capital and an adequate protection of the public, creditors and shareholders (see 'Comments on the Companies Act: 1959 Model' (1959) 1(2) Tas ULR at 304).

\(^74\) Some of the problems for the poor drafting of s 49 of the 1958 Act include: Firstly, the section dealt only with the payment of 'commission' on shares. Secondly, there is no restriction on the issue of debentures or other loan securities at a discount. Perhaps because of the assumption that loan securities do not form part of the company's share capital. That being the case, the payment of such 'commission' on such securities therefore, does not erode shareholder's funds but merely adds to the cost of the borrowing. That being the case, what about the issuing of loan securities which are convertible into shares? It was held in Mosely v Koffyfontein [1904] 2 Ch 108 that the issue of loan securities at a discount which are convertible as par into shares as an issue of shares at a discount. It may be thought that s 49 should have extended to cover the payment of commissions on convertible loan securities

—more particularly so in a case where the loan are convertible into shares at the option of the company. A third problem with s 49 is that it does not make clear an understanding of the source of fund out of which a company may pay say, an underwriting commission. Thus, as in Hilder v Dexter [1902] AC 474, there is no prohibition in that section on an underwriting commission being payable by the granting to the underwriter of an option to take up further shares.
& 118 of the *Companies Act 1981*, to be later re-enacted as sections 190 & 203 of the *Corporations Law* applying the prohibition at general law of issuing shares at a discount subject to exceptions in ss 117 and 118.  

There were three problems inherent in both ss 118(2) (a) (ii) of the 1981 Act and s 190 of the *Corporations Law*.

Firstly, it was unclear whether an ‘up-front dividend’ resulted in the issuing of shares at a discount. (In certain transactions concerning share capital, an issuer of redeemable preference shares may pay what is known as an up-front dividend to the investor immediately upon issuing the shares). Obviously, a payment to allottees by a company upon the issue of shares may fall within the prohibition in s 116(1) which forbids a company applying its ‘capital money’ in making a payment to a person in consideration of that person subscribing for shares in the company. The payment could also breach the s 116(2) prohibition against issuing shares at a discount if ‘discount’ were interpreted broadly to include payments. Prima facie, discount would appear to cover a payment by way of rebate. It is thus possible, that an up-front dividend could breach s 116, though this would not be the case if the dividend is paid out of profits.

Secondly, there was little guidance as to how the courts were to exercise their powers to confirm an issue of shares at a discount. This resulted in the decision of *Re Air North West Pty Ltd*, where McClelland rightly put it:

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75 The prohibition in s 116 arguably, is against issuing shares for less than par value, not against issuing them at below market value: *Heldt v Dexter* [1902] AC 474.

76 It is to be noted that the *Ooregum* decision was incorporated in, but modified slightly by s 190, which provided that No Liability (“NL”) companies could issue shares at a discount. The rationale for this is simple. As with other companies, a “NL” company can issue shares partly paid to any amount it chooses. Having done so, the partly paid shareholders are not obliged to contribute the uncalled amount of liquidation. In practical terms, this is no different to allowing the issue of shares as fully paid at a price below par. Because the general statutory prohibition against issuing shares at a discount did not under the other s 118 of the 1981 Act or under s 190 of the CL apply to ‘NL’ companies, the first concern feature (the imperative to maintain capital) would have only a qualified operation in the case of such companies). However, as already indicated under the English approach above, the ‘no discount’ restrictions have several undesirable consequences for limited companies as a whole. (See the discussion in the body of the text that follows this note).

77 *Maddiford v De Vantee* [1951] SASR 259 at 263.

78 (1988) 6 ACLC 1143. It is to be noted that this case did not just concern solely the issue of how the courts were determine the sanction of a discount share issue, it also impinges on the question under *Re Jurase Pty Ltd* (1988) 6 ACLC 769. (See below, n 79). In *Re Air North West*, the courts held that there was a legitimate commercial justification for issuing shares at a discount. Refer also to an earlier decision in *Re Edinburgh & Dundee investment Co* (1930) SC 601 where it was held that in determining how to sanction a share discount issue, the courts must weigh the pros and the cons of a proposal and not merely rubber stamp what the company has done.
Chapter 7  

7.2. Legislative History: No Discount Shares (Australia)

In my opinion, the court should ordinarily confirm a proposed issue of shares at a discount if it is satisfied that the issue has a legitimate commercial justification and that it is not likely to operate to the prejudice of any interested person. The courts may impose terms and conditions to secure these matters in appropriate cases.\(^7\)

The third difficulty of translating the provisions above was initially raised in *Re Jarass Pty Ltd*.\(^8\) The question being whether in an agreement under a scheme of arrangement where a company proposed to issue its shares in consideration of cancelling a debt—whether such constituted the issue of shares at a discount which was prohibited by law unless confirmed by an order of the court under s 118. Young J, being guided by English precedents,\(^9\) held that such a scheme did involve issuing shares at a discount. He however, contended that an off-setting transaction was only possible if the allotting company had an existing capacity to pay the relevant debts in cash. *Re Jarass* was further considered in *Pro Image Studios Ltd v Commonwealth Bank of Australia*\(^10\) where the court refused to follow the ruling in *Re Jarass*, held that, where a debt was immediately due and payable, the issue of shares in consideration of the extinguishment of a debt due of a sum equal to the nominal value of the shares was not an issue at a discount.

Where an insolvent company was released from debts owed to its unsecured creditors by allotting the creditors shares with a nominal value equivalent to its debts, it was an issue

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\(^7\) Ibid.

\(^8\) (1988) 6 ACLC 769. The issue here was whether an arrangement arrived at between the company and its creditors by which the company proposed to issue its shares in consideration of the cancellation of a debt, whether such an arrangement was within the prohibition of issuing shares at a discount under ss 118 & 190 of the *Companies Acts 1981* and s 125 of the *Corporations Law*.

\(^9\) Refer generally to; *Ooregum Gold Mining* above n 30; *Osborne v Steel Barrel Co Ltd* [1942] 1 All ER 634 at 638; *Stoton Varayton Commercial Investment Co Ltd* (1983) 1 AC 501 at 515; *Re Johannesburg Hotel* [1891] 1 Ch 119 CA.

\(^10\) (1991) 4 ACSR 586 at 588. There, the court held that a shareholder may with the company’s consent off-set a debt owing by company against a liability on the company’s shares even though the company has no present capacity to otherwise discharge the debt. This case involved an application for a declaration that a particular transaction was not an issue of shares at a discount within the meaning of s 190 of the CL. The case arose by reason of the decision of Young J in the Supreme Court of NSW in *Re Jarass Pty*, whereby, in a scheme of arrangement, whereby most creditors were to accept about 12c in the dollar in full satisfaction of their debts whilst others ('internal creditors') would not be paid the 12c but would each be allotted one redeemable cumulative preference shares of $1 for each dollar of indebtedness. No money was tendered or to be paid for these shares but the company’s liability to the internal creditors would be fully satisfied by the allotment of the shares. Young J relying on *Ooregum Gold Mining* held the scheme did involve the issue of shares at a discount. This case
for a payment in cash by set off equal to the nominal value of the shares. Although the law as to off-setting debt seem to have been ‘resolved’ in Pro Image, the C&SLRC suggested that, it would be necessary to examine the value of the consideration passing from the company which issued the shares. Partly due to the decision in Pro Image, and the legislature’s attempt to fine-tune the law on share discount issue, ss 118, 190 were repealed by s 258C of the Corporations Act 2001. Under s 258C, a company has an express statutory power to issue shares at a discount in the form of paying brokerage or commission as consideration for an issue of shares. This shift in legislative policy arose as a result of the demise of the par value regime, with company shares having an issue price but no nominal or par value. Accordingly, the concept of a discount share issue was no longer relevant.

7.2.2.3. Non Cash Consideration

Section 55 of the Companies Act 1899 (NSW) re-enacted s 25 of the 1867 Act (UK) authorising companies to lawfully issue shares as fully or partly paid-up for a consideration which the company has agreed to accept as representing in money’s worth the nominal value of the shares. The issue as to whether a company could issue shares as fully or partly paid in consideration of past or future services was initially addressed in

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83 In Pro Image (Ibid), Fullagar J put it thus:
It is the debt which is released that counts, not some assessed value to the creditors of the debt owed to him based upon prospects of realization or execution of or upon the debt provided that the debt was genuinely created in the course of the company’s business...and provided that it is immediately payable...the issue of shares in consideration of the extinguishment of a debt of a sum equal to the nominal value of the shares issued is not an issue at a discount but is an issue for a payment in cash equal to the nominal value of the shares.

84 A ‘brokerage’ is a fee or commission paid to a broker in return for a service. A ‘commission’ is a reward paid for a service.

85 It is to be noted that prior to the current amendments in the law, older statutes did allow companies to issue shares at a discount by way of brokerage or commission.

86 Corporations Act 2001 (Cth), s 254C.

87 One of the reasons for allowing companies to issue shares at a discount under the current law may be that under the par value regime, shares might well be below their value especially where the company has traded profitably for a long period, but also due to the fact that the company might accept non-cash consideration for the payment of shares. Refer for example to Wright v Mansel (2001)39 ACST 580 where it is firmly established that subject to statutory qualification, a company cannot issue shares at less than their par value even where its memorandum gave it power to do so.

88 See, Pellett’s case (1867) 2 Ch App 527. See, also, in Re Baglan Hall Colliery (1870) 1 R 5 Ch App 346; Re Almeida & Tinto (1888) 38 Ch D 415 & Oerregum Gold Mining, above n 30. These cases illustrative that so long as the company honestly regards the consideration as fairly representing the nominal value of the shares in cash, its estimates ought not to be critically examined.
7.2. Legislative History: Non-cash Consideration (Australia)

Re Casey's Patent where the courts decided that future consideration was adequate consideration. This case was overruled in Re Eddystone which itself was reversed by the House of Lords in Re Wragg Ltd with a principle firmly established that although a company cannot issue shares at a discount, it can, provided a contract is duly registered, buy property at any price it thinks fit, pay for such property in fully paid-up shares in money's or money's worth. Re Wragg also recognised that, past or future consideration is prima facie good consideration. The decision in Re Wragg, was applied in the case of Cmr of Stamp Duties (NSW) v Perpetual Trustee (Saxton's case),\(^9\) to the effect that, a limited company could not allot shares on the basis that non-cash consideration, such as goodwill or services, to be supplied at some future time. Due to the decision in Saxton's case, s 46 was inserted in the Company's Act 1958 (Vic) to reflect the prevailing issues relating past and future consideration. The above legislation was re-enacted as s 56 of the Uniforms Company Act 1961.

In 1971, the Eggleston Committee\(^9\) recognised that the previous Companies Acts and the decisions arrived at in Re Johannesburg Hotel\(^9\) and Saxton's case, concerning the question whether cash-off-setting was good consideration may be problematic and unclear. They suggested that the legislation should ensure that the disclosure obligations in the Companies Acts were not avoided by off-setting cash issue. This was not implemented. The old law continued to apply and was re-enacted as s 113 of the Companies Act 1981,

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\(^8\) (1929) 43 CLR 247 at 264. There, it was decided that the liability upon shares cannot be discharged unless the company obtains in funds or assets that which is, or is supposed to be, a real equivalent to the capital represented by shares. Thus, although an agreed extinguishment by set-off of liability of the shareholders to the company and of the company's liability to him is undoubtedly payment, yet probably it is not competent to a company to incur a voluntary liability for the purpose of enabling such a set-off to be bad. This case which seems to be inconsistent with Re Wragg but consistent with Re Eddystone, the court held that if non cash consideration in the form of services is postponed, this may contravene s 527 of the Act in the sense that the issuing company would forgo the speciality status of calls, and in its stead, the company would only be able to recover the non-cash consideration as a simple contract debt. Cf Knox & Dixon CJJ (at 249) who argued that whether with or without a filed agreement, a company may not extinguish the shareholders liability for a simple contract debt. According to Isaac J, it was ultra vires of a company to accept as payment of share liability the substitution of another promise to pay that liability.


\(^9\) [1891] 1 Ch 119. There it was by Lord Halsbury LC that there can never be any cross debts between the company and its allottees under a contract to take fully paid up shares, and, consequently, no payment can be effected by accepting the extinction of one debt as to the satisfaction of the other.
which in line with certain authorities, allowed a subscriber to off-set any debts of the company against a subscription debt (i.e., a shareholder may, with the company’s consent, off-set a debt owed by the company against a liability on the company’s shares even though the company has no present capacity to otherwise discharge the debt).

As to the method for valuing non-cash consideration, s 113 modeled from the Companies Acts 1867 and 1948 (UK) now repealed by the 1985 Act, was to effect that, any consideration which was carried on an ‘honest estimate’ by the directors of the company as to the value of the assets and was not tainted by fraud or misrepresentation, was considered an adequate valuation for the shares. Comparatively, while the ‘director’s honest estimate’ approach is analogous to those of other jurisdictions such as New Zealand, Canada and the US, in the UK, France and Germany which implemented the 2nd EU Company Directive, now ss 99-116 of the 1985 Act (UK), implement the ‘Independent Expert Valuation’ method as the optimum approach for the valuation of non-cash consideration. The Companies & Securities Law Review Committee which made some suggestions on this issue of non-cash valuation did not consider the contemporaneous ‘expert valuation’ mechanism as appropriate because, in their view, it would impose too costly a burden upon the commercial community.

The C&SLRC, however, recommended that provisions be made that a company may not issue shares for non-cash consideration unless the directors have made in good faith a determination of an amount of money that would have been payable by the company to obtain the non cash advantage to be required by the issue of the shares. Section 187 of

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92 See for example; Re Johannesburg Hotel: Sexton’s case above n 70; Messer v DFCT (1934) 51 CLR 472 at 478; FCT v Steeves, Agnew & Co (Vic) Pty Ltd (1951) 82 CLR 408 at 420; Re Jaruss and Pro Image cases.

93 This proposition which was laid down in Re Wragg Ltd, was evoked in Stanton (Inspector of Taxes) v Drayton [1983] AC 501 to the effect that, when shares have been issued for a consideration other than cash, it must be assumed that the directors have done their duty and unless the transaction is impeached by fraud, it is not permissible to inquire into the adequacy of the consideration.


95 Ibid. The recommendation which was adopted since remains the state of the law till present. See, also, Salomon v Salomon [1897] AC 22; [1895-99] All ER 33 HL; Official Assignee v Walker (1995) 7 NZCLC 260.640 at 260.656; Park Business Interior Ltd v Park [1992] BCLC 1034 at 1040. In all these cases, the directors ‘honest valuation’ test has been repeatedly used to determine the valuation of non-cash issues. One holds the view that the ‘expert valuation approach’ may be more compelling in the sense that being experts in the first place, their estimate may provide a nearer to a fair value for non-cash shares than that proscribed by the directors. Moreover,
the Corporations Law which adopted the C&SCLR recommendation, amended s 113 by requiring companies allotting shares for non-cash consideration to lodge any written contract duly sealed by the parties with the Australian Securities Commission. The requirement has been reenacted by s 254X of the Corporations Act 2001(Cth) to the effect that companies issuing non-cash shares under a contract are required to lodge with ASIC a certificate stating that all stamp duty payable on the contract has been paid. Companies are also required to comply with a statutory disclosure notice. This requirement which applies only to public companies is inserted as s 254X (1) (e) requiring public companies to lodge such statutory notice with the Australian Securities Investment Commission. The purpose of this disclosure condition is to enable any person searching the public records of a company to confirm that the consideration provided for shares is not less than would have been the cash liability for them.

7.3. Some Policy Problems relating to the Consideration for the issue of Shares

7.3.1. Payments for non-cash consideration & the principle of circuitry

7.3.1.1. Discharging a Specialty Debt.

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96 As far back as in Ooregun Gold Mining, and in Moseley v Koffi Fontein Mines Ltd [1904] 2 Ch 108 At 117, the courts have recognised that creditors might be prejudiced from an improper valuation due to the lack of an expert procedure. From this perspective, in the absence of an expert valuation mechanism, there is the likelihood that either creditors or shareholders may be at risk of an overvaluation or even under valuation of their shares from the directors 'honest estimate' test. (For an optimum regulation, see the arguments below, section 7.3).

97 The purpose for lodging such written contract with the "ASC" is that since the development of Joint Stock Companies made it possible for unscrupulous promoters to acquire assets and then revalue them to unrealistically high levels and then sell them to newly promoted companies in which members of the public were induced to invest by questionable forecast and other misleading statements, to meet the mischief of promoters and others secretly taking issues of shares in return for inadequate non-cash consideration the Corporations Law requires disclosure of details of the contract under which the shares are issued.

98 Official Assignee v Walker (1995) 7 NZCLC 260, 640 per Tompkins J. This disclosure required of public companies by s 254X(1) (e) only necessary if shares are properly regarded as having been allotted otherwise than for cash. If there are two off-setting cash transactions, s 254X (1) (e) will be inapplicable. Although the Eggleston Committee recommended legislation to ensure that the disclosure obligation was not avoided by such a
7.3. Policy Problems (Specialty Debt & Share Premium)

7.3.1.1. Specialty Debt and Share Premium

As previously indicated, though the par value regime and the treatment of a share premium account are redundant in Australia, subscribers for shares are still required to provide full value for issue price. The failure to do so creates a specialty debt. In Re Wragg,99 Lindley LJ examined the nature of the liability of a shareholder for the consideration of his shares:

The liability of a shareholder(s) to pay the company the amount of their shares is a statutory liability, and is declared to be a specialty debt100 and a short form of action is given for its recovery.101 But specialty debts like other debts, can be discharged in more ways than one-e.g. by ‘payment’, set-off, accord and satisfaction and release, and subject to the qualifications102 introduced by the doctrine of ultra vires, or in other words, the limited capacity of statutory corporations, any mode of discharging a specialty debt is as available to a shareholder as to any other specialty debtor…103

Presumably, it is reasonable for a shareholder to be liable for the amount unpaid on its shares in a winding-up, although a shareholder has no statutory liability to contribute an unpaid premium in a winding-up.104 However, a company, or its liquidator, may have a contractual right to claim an unpaid share premium from a subscriber.105 Under the Corporations Law, if a company’s constitution provided for the liability of members for unpaid premiums, that liability was in the nature of a specialty debt for the purposes of s

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99 [1897] 1 Ch 796.
100 See, Companies Act 1862, s 16. Section 75 of the same Act makes it a specialty debt accruing to shareholders when their liability commenced.
101 Ibid s 70.
102 The qualifications to the general proposition mentioned by Lindley LJ are:

... It is however, obviously beyond the power of a limited company to release a shareholder from his obligation without payment in money or money’s worth. It cannot give fully paid up shares for nothing and preclude itself from requiring payment of them in money or money’s worth: Re Eddystone Marine Insurance Co[1893] 3 Ch 9; nor, can a company deprive itself of its right to future payment in cash by agreeing to accept future payments in some other way. It cannot substitute an action for a breach of a special agreement for a statutory action for non payment of calls: Re Richmond Hill Hotel Co (“Pellatt’s case”) (1867) LR 2 Ch App 527. Cf Cnr of Stamp Duties (NSW) v Perpetual Trustee Co Ltd (“Saxton’s case”) (1929) 43 CLR 247, 264.
103 [1897] 1 Ch 796 at 829. The principle enunciated there was that; although, a company was prohibited from issuing shares at a discount under the 1862 Act, it can , provided the contract was duly registered under s 25 of the 1867 Companies Act, buy property at any price it thinks fit, and pay for such property in fully paid-up shares. The transaction is valid and binding upon creditors so long as the company has acted honestly and, unless the contract can be impeached for fraud, the value received by the company is to be measured by the price at which the company agreed to buy the property.
105 See, for example, Re Vedelego (1992) 8 ACSR 135 at 138 per Williams J.
180(2).\textsuperscript{106} A company, therefore, could not agree to the specialty debt being replaced with a simple contract debt.\textsuperscript{107} Section 140 of the current law says nothing about amounts owing to a company under its constitution being specialty debts. Accordingly, while share premiums no longer apply because of abolition of par value, subject to any agreement in the contrary, a shareholder who acquired shares at a premium has no right to have the premium returned in a winding-up.

Thus, in \textit{Re Driffield Gas Light Co}, it was held that share premiums are treated as residual assets distributed in the same way as other residual assets after creditors have been paid. Since the Corporations Act has rendered redundant the concepts of a share premium and discount issues, this would be the correct approach in interpreting s 140. However, because s 14(2) of the \textit{Company’s Act 1985} regards such liability to be a specialty debt, it might be possible to suggest that under that jurisdiction, since a share premium is considered as part of share capital, the liability of the unpaid premium must be regarded as a specialty debt.\textsuperscript{108} This would be consistent to the repealed s 182(2) of the \textit{Corporations Law}.

\subsection*{7.3.1.2.2. Extinction of a specialty debt by Future Supply of Goods and Services.}

At common law, a company could lawfully lend money to buy its shares.\textsuperscript{109} However, a company may not have been able to voluntarily incur a liability in order to facilitate an off-setting cash consideration in relation to its shares. Such a transaction would result in the company loosing the benefit of the specialty debt status.\textsuperscript{110} Also, under case and statute law, companies could accept payments in ‘cash’ or ‘money’s worth’ as adequate

\begin{footnotesize}
\begin{itemize}
\item[106] See, \textit{Re Me and Angus Pty Ltd} (1992) 7 ACSR 748; 10 ACLC 1033 at 1035 per McLelland J.
\item[107] Ibid.
\item[108] Cf. Great Britain, Company Law Review Steering Committee Group (1999) at 7. The Committee suggested that they do not think it necessary to keep the substance of s 14 (2) that a debt owed by a member to the company to be considered a specialty debt. They argue that the idea of a specialty debt, dates back from an era when the analogy between the company’s constitution and deeds of settlement was still powerful.
\item[109] \textit{Durack v West Australian Trustee Executor & Agency Ltd} (1944) 72 CLR 189 at 220; \textit{Mountain View Charolais Ranch Lid v Haverland} [1974] 2 WWR 289.
\item[110] \textit{Commissioner of Stamp Duties (NSW) v Perpetual Trustee Co Ltd} (Saxon’s case) (1929) 43 CLR 247 at 264 per Knox CJ and Dixon J dicta.
\end{itemize}
\end{footnotesize}
7.3. Policy Problems (Specialty Debt & Goods & Services)

consideration.111 Where shares are paid for in ‘cash’ then ordinarily the set-off of a debt owed to the shareholder is ‘cash’ if the claims are otherwise eligible for set off, but a future supply of goods or, a future performance of services by the subscriber in return for the shares is not payment in cash in Anglo-Australian law.112

Consequently, an amount not less than the value of the share will have been received, and, must be entered into the corporation’s books as an addition to the corporation’s assets. Because shares may be paid in money or moneys worth including ‘services rendered’113 what is the ‘serious’ problem involved for a shareholder to discharge its specialty debt for future calls by the future supply of goods and services valued at the amount of the subscription price?114 While the nature of the future supply of goods and services to discharge a specialty debt may be abused, it is also reasonable that the subscription price may in limited cases, be paid by the performance by the subscriber of services, or by the transfer of property if so agreed, or by a reciprocal set-off of the subscription price and the price which the company is to pay for the goods and services.

Indeed, in Ooregum Gold Mining,115 Lord Halsbury regretted that the statutory prescription that shares are held ‘subject to the payment of the whole amount in cash’116

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111 The term ‘cash’ was defined by s 738 of the Companies Act 1985 (UK) to include: (a) cash in foreign currency, (b) release of the liability of the company for a liquidated sum (c) an undertaking to pay cash to the company at a future date. The term ‘money’s worth’ was also meant to include goodwill, exchange of property and ‘services rendered’.

112 Cf. Companies Act 1985 (UK), s 99(2); Canadian Business Corporations Act 1990, s 25(1). See, also section 254X (1) & (2) of the Corporations Act (Cth) which makes provision for prescribed particulars about the issue of shares (whether in cash or non-cash consideration) to be lodged with ASIC within one month after issuing shares.

113 The law also recognizes that a company may agree to pay for goods or services in advance of receiving them, and then allows a subscriber to off-set the company’s existing liability to pay against the subscription debt: Cf Re Theatrical Trust Ltd (Chapman’s case)[1895] 1 Ch 771.

114 According to the 2nd EC Directive, art 9 prohibits companies from accepting undertakings to do work or perform services as consideration for the allotment of shares. See also, Companies Act 1985, s 102 (UK). Case law to this effect include generally, “Saxton’s case, above n 71; Re Richmond Hill Hotel Co ("Pettitts case") (1867) LR 2 Ch App 527; Re Wragg; above n 82.

115 [1892] AC 125

116 Company’s Act 1867 (UK), s 25.
had received a judicial exposition which allows a payment otherwise than in cash. But, Lord Watson in the same case, pointed out:

A company is free to contract with an applicant for its shares; and when he/she pays in cash the nominal amount of the shares allotted to them, the company may at once return the money in satisfaction of its legal indebtedness for goods supplied or services rendered by him. That circuitous process is not essential. It has been decided that, under the Act of 1862, shares may be lawfully issued as fully paid up, for consideration which the company has agreed to accept as representing in money's worth the nominal value of the shares. I do not think any other decision could have been given in the case of a genuine transaction of that nature where the consideration was the substantial equivalent of full payment of the shares in cash. The possible objection to such arrangement is that the company may overestimate the value of the consideration, and, therefore, receive less than nominal value for its shares. The courts would doubtless refuse effect to a colorable transaction entered into for the purpose or with the obvious result of enabling the company to issue its shares at a discount; but it has been ruled that, so long as the company honestly regards the consideration given as fully representing the nominal value of the shares in cash, its estimate ought not to be critically examined. That state of the law is certainly calculated to induce companies who are in want of money, and whose shares are unsaleable except at a discount, to pay extravagant prices for goods or work done to persons who are willing to take payment in shares. The rule is capable of being abused, and I have little doubt that it has been liberally construed in practice.\footnote{117}

In \textit{Re Casey's Patent, Stewart v Patent}\footnote{118}, there was an agreement between the parties in which an entry on the Register of Patents was to be made under ss 23, 85 and 87 of the \textit{Patents \\& Companies Act 1883}. The consideration as stated reads:

\begin{quote}
“It is in consideration of your services as a practical manager in working our patents for transit for steamer; we agree to give you one third share of the shares…”
\end{quote}

The question was whether such services amounted to an adequate consideration for shares. The defendant argued that it was a past service that was meant in the agreement, so therefore, past services are not a consideration for anything. Bowen LJ posited that the consideration must be something other than rendering services in the future. It is the promise to render itself that constitutes the consideration.\footnote{119}

\footnote{117} Ibid 136-137.
\footnote{118} [1892]1 Ch 104. Cf \textit{Re Eddystone Marine Insurance Co} [1893]3 Ch 9.
Bowen LJ commented:

Even if it were true as some scientific students of law believe, that a past service cannot support a future promise, you must look at the document and see if the promise cannot receive a proper effect in some other way. Now, the fact of a past service raises an implication that at the time it was rendered it was to be paid for, and, if it was a service which was to be paid for, when you get in the subsequent document of promise to pay that promise may be treated either as an admission which evidences or, as a positive bargain which fixes the amount of that reasonable remuneration on the faith of which the service was originally rendered ... Therefore, this is an equitable assignment which cannot be impeached.\(^{120}\)

Therefore, a promise to supply goods or render services in the future was good consideration. A similar issue was considered in \textit{Re Eddystone Marine Insurance Co.}\(^{121}\) There, a company formed under the \textit{Companies Acts 1862-1887} entered into a contract with its shareholders under s 25 of the 1867 Act to allot shares (fully paid shares) to the directors and shareholders in consideration of their past services. According to the agreement, the company was indebted to these members and so for their past services to the company, they were remunerated with certain bonus shares. It was agreed that each of the shares would be deemed to be fully paid and free from liability. The company was wound-up and the liquidator placed the directors and original shareholders on the list of contributories for the shares. The question was whether such 'past services' were good consideration? Solicitors for the shareholders argued that the contract was ultra vires and that the court should release them from the contract and from liability.

Wright J, holding the shareholders and directors liable said:

As I understand the law, shares cannot be paid except by money or money’s worth and a contract apart, shares cannot be paid for by treating as a debt that which was not a debt at all. It is an old established principle that parties who are sought to be made contributories in respect of shares which have been allotted to them as fully paid up cannot get out of their liability to pay the calls on such shares merely on the allegation that it was ultra vires to issue shares in that form\(^{122}\)

\(^{119}\) Ibid 115.
\(^{120}\) Ibid, 116.
\(^{121}\) [1893] 3 Ch 9.
\(^{122}\) Ibid at 10.
Chapter 7

7.3. Policy Problems (Specialty Debt & Goods & Services)

Neville QC (on appeal), held that there is no case which decides that, where there is a registered contract to issue shares, made bona fide but not for money consideration, the company cannot issue shares as fully paid up and there is nothing in the public policy to forbid it. The registration of the contract is sufficient and adequate protection of the public. Although the company owed no legal debt to the shareholders, the services they rendered were sufficient consideration.\(^{123}\)

Similarly, in *Re Wragg*,\(^{124}\) the basic fact was that the company had been formed to take over the existing unincorporated business of Wragg. The company soon failed and the official liquidator issued a summons of misfeasance on the grounds that the property purchased (which included goodwill and stock in trade) had been over valued and that, as a result, the shares issued as fully paid in satisfaction of the debt were, in fact, issued at a discount. The question was whether shares credited as fully paid-up and issued to the vendors of the business which the company bought were improperly issued. The court held that although a company cannot issue shares at a discount, it can, provided the contract is duly registered, buy property at any price it thinks fit, and pay for such

\(^{123}\) Ibid, at 16. Contra Lindley L.J who said

> Can a limited company give its members fully paid up shares for nothing, so that when the company is wound up those shareholders are not liable to pay calls in respect of those shares? The answer to that question of law is clearly that they cannot do it. It is contrary to the Act of Parliament. According to *Oregum Gold Mining*, a company cannot issue shares at a discount so as to relieve a person taking shares at a discount from liability to pay the proportion of the shares which has not been paid (at 18).

*Cf. Henderson v Bank of Australia* (1897) 40 Ch D 170.

\(^{124}\) [1897] 1 Ch 796. The Court of Appeal held that it was well established that an acquirer of shares from a company whether as subscriber to the memorandum or by issue and allotment could satisfy the liability in respect of those shares by paying money or money’s worth and, the court could not go behind the agreement made by the company and shareholder except in very limited circumstances. As Lindley L.J put it in the same case:

> It has ... never yet been decided that a limited company cannot buy property or pay for services at any price it thinks proper, and pay for them in fully paid up shares. Provided a limited company does so honestly and not colorable, and provided that it has not been so imposed upon as to be entitled to be relieve from its bargain, it appears to be settled by *Re Heyford Company* (*Pell’s case*) (1869) LR 8 WQ 222. *In re Wedgwood Coal & Iron Co* (*Anderson’s case*) (1877) 7 Ch D 75; that, agreements by limited companies to pay for property or services in paid-up shares are valid and binding on the company and their creditors.(at 805).

It should be noted that the first judicial consideration of the questions involved with the adequacy of non cash shares was the *Pells* case. There, received his shares in the company in exchange for his interest in the goodwill and stock in trade of a business, which he transferred to the company. The company was wound-up. The official liquidator argued that an enquiry should be ordered into the adequacy of the consideration offered. It was held so far as the value of the non cash was equivalent to the nominal value of the share, the adequacy of the consideration need not be inquired into, unless the contract can be impeached for fraud. This requirement that the adequacy of the consideration could not be inquired into without there being evidence available with which to impeach the subscription contract (“the impeachment rule”) was reiterated in *Re Baglan Hall Colliery Co* (1870) LR 5 Ch App 347. There, Giffard L.J. again reiterated the rule that a subscription contract entered into for non cash consideration could only be examined for adequacy of consideration if there was evidence available with which to first impeach it.
property in fully paid up shares. Any such transaction was valid unless it was impeached by fraud the law could not inquire into the adequacy of the consideration. The value received is to be measured by the price at which the company agreed to buy the property, and the courts need not inquire into the adequacy of the consideration. As concerns the nature as to whether the future supply of goods and services was sufficient consideration, it seems apparent that in *Re Wragg*, it was held that such nature of agreement was not valid because this was an agreement that future calls may be satisfied by an action for breach of contract to supply goods.

So far as the law of contract is concerned, a gratuitous promise is not legally enforceable unless the contract was legally sealed or, there was a ‘genuine bargain’. In the above case, the Court of Appeal held that a contract for non cash consideration (whether in the form of past or future promise) duly signed by the parties was a real contract and a real consideration is transferred against fully paid shares. Unless the agreement to which shares were to be paid for in property or services could be impeached for fraud, the value of the consideration could not be inquired into.

While the courts above, had different opinions, it seems apparent that in *Saxton’s case*, a similar question was whether a subscriber could discharge its specialty debt by the future supply of goods and services. The *Corporations Act* prohibits any conversion of the nature of the shareholders’ liability which allows a subscriber to provide non cash, consideration such as goods and services, to be supplied at some future time.

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125 Lord Justice Lindley said:-

As regards the value of the property which a company can take from a shareholder in satisfaction of his liability to pay the amount of his shares, there has been some difference of opinion. But it was ultimately decided that, unless the agreement pursuant to which shares were to be paid for in property or services could be impeached for fraud, the value of the property or service could not be inquired into. In other words, the value at which the company is content to accept the property must be treated as its value as between itself and the shareholder whose liability is discharged by this means ... (at 810).

126 According to the *Companies Act 1867*, § 25 is to effect that a non cash consideration under contract or agreement, and where the value of the consideration is equal to the nominal value of the shares is valid and enforceable unless the contract can be impeached (Sometimes known as the “impeachment doctrine”).

127 The court there, cited a number of cases which supported or followed its theory: *Ooregum Gold Mining*, above n 27; *Re Almada Tirlo*, above n 26; *Pells case* (1869) LR 8 Eq 222; *Re Baglan Hall*, above n 31.

128 *Saxtons*, above n 89.
According to this decision, the transaction would cause the issuing company to forgo the specialty debt status of calls under s 527\(^\text{129}\) which will only enable the company to recover the non cash consideration as a simple contract debt. The Supreme Court of NSW was quick to acknowledge that although set-off is an acceptable way by which mutual claims may be discharged, the liability upon shares cannot be discharged unless the company obtains in funds or assets that which is, or is supposed to be, a real equivalent to the capital represented by the shares. Thus, although an agreed extinguishment by set-off of the liability of the shareholder to the company and of the company’s liability to him is undoubtedly payment, yet probably it is not competent for a company to incur a voluntary liability for the purpose of enabling such a set-off to be had, otherwise than in the ordinary course of its business.\(^\text{130}\)

In *Re Richmond Hill Hotel (Pellat’s case)*,\(^\text{131}\) a shareholder agreed to take shares on the basis that the company would order goods from him and the price would be set-off against the subscription price for the shares. No shares were ever issued. The company was wound-up. The question arose as to whether there was a valid contract to take shares. The court held the contract was ultra-vires the directors and therefore the shareholder was not bound by it. Even if the contract were valid, the company being wound-up could no

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\(^{129}\) *Corporation’s Act 2001(Cth)*, s 527 provides:

A contributory’s liability is of the nature of a specialty debt according to the law of the capital territory accruing due from the contributory when the contributory’s liability commenced but payable at the times when calls are made for enforcing the liability.

See also, 2\(^\text{nd}\) E.C Directive, art 12 which specify that subject to the provisions relating to the reduction of the subscribed capital, shareholders may not be release from the obligation to pay for their contributions. But Cf *Saxton’s case* (per knox J) and *Pellat’s case* (by Dixon J); *Gardner v Iredale* [1912] 1 Ch 700, 716 (per Parker J). According to the court, any voluntary disposition by a company could not be used to facilitate an off-setting cash transaction. Therefore, by implication, express or implied, the shareholder could not provide future supply of goods and services to discharge its specialty debt to the company. See the rhetorical question of Lord Macnaghten in *Faiimatina Dev’l Corp Ltd v Bury* (1910)AC 439, 442.

\(^{130}\) [1867] LR 2 Ch 527, 535.
longer perform its agreement to order goods and hence it would be unjust to hold the shareholder to his agreement to take shares. Lord Cairns pointed out:

Without laying down any general rule, but looking only to the particular circumstances of the case, I entertain a strong opinion that the contract was ultra vires. The intention of the Act is, that shares shall be held as shares wholly or in part paid-up, or not paid up at all, and that, so far as they are not paid-up, the ordinary liability to pay up the remainder in cash, when required, should attach on the holder of them, and it is required to be entered on the register how much has been paid-up upon them. If some consideration is given, it may be quite right for the directors to state, on the register, that they are to be treated as in part paid up, though no money has passed, but I do not think it within their powers to contract that the calls, in respect of what remain to be paid up, shall be set off against goods to be supplied by the shareholder, and shall not be paid in money. The inconvenience arising from such a contract might be almost incalculable. Goods might not be supplied at all, or they might be supplied of such a quality that they ought to be rejected, and remedies against the shareholders might be unavailable, while the other shareholders had all along been paying in cash.\textsuperscript{132}

It seems clear that, with or without a filed agreement, a company may not extinguish shareholder’s liability with all its peculiar incidents by merely accepting in its place a liability for a simple contract debt. There appears to be no express decision exactly to this effect but it seems a necessary consequence of settled principles.\textsuperscript{133} In Pellat’s case above, Turner LJ was of the opinion that apart from the special circumstances under which the directors might possibly legally contract with a tradesman for him to take shares, such a contract would generally be ultra-vires of the directors, since under such a contract the company’s sole remedy for breach of the agreement would be an action for breach of contract, on which they could recover merely as for a simple contract debt, whereas, under the usual contract to take shares, calls on the shares were given by the Act of 1862 the rank of specialty debts.\textsuperscript{134}

\textsuperscript{132} Ibid.

\textsuperscript{133} However, Cf Pro Image Studios Ltd v Commonwealth Bank of Australia (1991) 4 ACSR 586.
Chapter 7  7.3. Policy Problems (Specialty Debt & Goods &Services)

In Re Richmond Hill Hotel Co (Ellington's case), a shareholder subscribed for shares on the basis that future calls would be paid for out of goods to be ordered by the company from him. The company never ordered the goods. The court held the shareholder was liable for calls on the winding-up of the company. But in, Gardiner v Iredale, a prospective shareholder company was a prospective lessee under an agreement for a lease. The shareholder agreed with a company that the shareholder would assign to the company the agreement for the lease and would build a theatre on the property. The price was $9000. The court said that if the contract could be read as a contract to build a theatre in consideration of $9000 payable at once with a provision that the $9000 shall be satisfied by the issue of fully paid shares to that amount, it would be valid.

It is understandable that problems can arise when a company agrees to allot shares in exchange for non-cash consideration such as future supply of goods and services but the allottee fails to provide the consideration within a reasonable time of the date of the agreement. The market value, for example, of the non-cash consideration may decline so that it can no longer reasonably be considered to be the equivalent to the value of the shares subscribed. Another justification why the acceptance of the future supply of goods and services cannot be considered as sufficient consideration especially in the European Union jurisdictions where the minimum capitalization requirement plays a vital role is that such arrangements may impugn the integrity of the minimum paid up capital by the exchange of shares for intangible consideration like future supply of goods and services. However, the position of the law as to the future supply of goods and services is still somewhat unclear.

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134 Ibid, at 527.
135 [1867] LR 2 Ch App 511.
136 [1912] 1 Ch 700.
137 Cf Corporations Act 2001 (Cth), s 254X (1) in relation to the timing of the lodgment of share issue, and s 254X(2) concerning the timing and informational requirements for non-cash consideration under contract.
139 It is less clear if a similar effect will apply in Australia where there is no minimum capital regime and where companies may incorporate with even $2. The same argument continues that, in the UK where the 'no discount rule' is still deeply rooted, a discharge of a shareholder of his specialty debt by the acceptance of future supply of goods and services may breach the rule which says shares cannot be issued at a discount. See the Oregum Gold Mining case. This might not likely be the same in Australia where the 'no discount rule' has been repealed.
Firstly, the Limited Liability Act recognized that a shareholder is liable only to the extent of his uncalled shares especially when the company is wound-up. It does not impliedly or expressly provide a time limit when the share liability will be discharged. By implication therefore, there is nothing seriously detrimental to creditors if a shareholder was to pay for its shares in the form of future supply of goods and services. Secondly, with the demise of the ultra vires doctrine, on which it is assumed most of the cases above are premised (i.e., a future consideration is an inadequate consideration), there is little reason to suggest bases of the principle regarding future consideration. To relate a future supply of goods and services to be insufficient consideration based on the ultra vires doctrine would be to recast an obsolete principle into modern law.

Thirdly, cases interpreting s 25 of the 1867 Act (UK) suggest that once a contract is duly signed and sealed and not tainted by fraud, then by implication, future consideration would discharge a specialty debt. To accept this view would be to recast the ‘impeachment’ doctrine. Section 25 is far long gone. And the impeachment doctrine serves little or no relevance in modern times.\(^\text{140}\) Fourthly, Anglo-Australian law recognizes that ‘cash off-setting’ is an appropriate way by which parties could discharge

\(^{140}\) Although, under a typical contract law, there is adequacy of consideration when parties come into a valid agreement. The argument from the contract and agency law perspective is that the adequacy of a consideration will depend on whether the contract was one of exchange or barter or, a reciprocal sale with set off of prices. Thus, where a shareholder transfers property to the company or perform services for the company in exchange for its shares, this may be inadequate consideration. If on the other hand, the shareholder agrees to sell property or render services to the company for a stated price, and the parties agree to reciprocally set off that price and the subscription moneys that should be payment in ‘cash’ and should be regarded as an adequate consideration. For example, see, Re Harmony & Montague Tin & Copper Mining Co (Spargo’s case) (1873) LR 8 Ch App 497. Cf Re Church & Empire Fire Insurance Co (“Andreas’s case”) (1878) 8 Ch D 126. There, a newspaper proprietor agreed to run the prospectus of a company in their newspapers as advertisement in return for fully paid shares. The company was subsequently wound-up. The court held the shareholders had not paid in cash. Jessel MR said in the course of the decision that:

If I say to newspaper proprietor, “if you will insert this advertisement for me I will give you a horse” .Can this be made out to be a payment in cash? How could [the newspaper proprietor] at law support a plea of payment? The company never owed him any money, and never intended to owe him any. They no doubt entered into arrangements of this kind because they wanted to issue advertisements, and had no money in hand with which they could pay for them. I cannot see any pretence for saying that this was payment in cash, or anything which would support a plea of payment in law.

For the contract law arguments, refer generally, to, Hocker, Dafy & Heffey, Cases and Materials on Contract, (5th ed) (1985) 89. Refer also to, Phillip Wood, English & International Set-Off (1989) 722; Benjamin, Sales of Goods, 3rd ed (1979) 31. We should however keep in mind when interpreting the rules of consideration in contract law to those as applied under the corporation’s law. Although they may be addressing similar issues, they also have the tendency to conflict.
their liability to each other, (i.e., a company may agree to pay for goods or services in advance of receiving them, and then allow a subscriber to off-set the company’s existing liability to pay against the subscription debt). It is open to doubt whether s 99(2) of the English Company’s Act or its Australian equivalent which prohibits future supply of goods and services will be infringed if the company for example, agrees to pay a stated price for the goods or services and then the parties reciprocally agree to set-off that price and the subscription money.

Lindley CJ in Re Wragg mentioned that a specialty debt like any other debt could be discharged by ‘payment, set-off, discharge, release, accord and satisfaction. If those methods are broadly construed, it can be question as to whether the payment of future calls in discharging a specialty debt do not fall within the ambit of the various ways by which such debt could be discharged? A seemingly difficult problem with future calls is that case law allows a company to acquire assets on credit and then to subsequently pay for them by allotting shares to the vendor without allowing the company to accept future calls. The argument on the company’s side is that, since ‘cash’ includes the release of a liability for a liquidated sum, the shares would prima facie be allotted for cash: in Re Bradford Investments plc (No 2). Hoffmann J, referring to this type of situation commented:

I would not wish to give the impression that an artificial resort to two documents instead of one could be used to avoid the provision (requiring independent valuation of non cash consideration for shares. However, whilst the courts may be expected to be vigilant to ensure that statutory requirements are not evaded, where there is no question of the two stages of the transaction being artificial or a sham, the shares will be treated as being allotted for cash.

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141 See, for example, Chapman’s case, above n 87; Gardner’s case, above n 94. Although according to the nature of cash offsetting there must be mutual debts and mutual claims, it does not by implication cancel the fact that parties cannot contract out of set-off although a ‘mandatory rule’: National Westminster Bank Ltd v Halesowen (1972)AC 785 (in this sense, one is referring to insolvency set-off).

142 After all, under the English Legislation, an agreement by a private company to allot shares in consideration of services to be performed in the future renders the allottee liable to pay for the shares: National House etc, Investment Co Ltd v Watson [1908] SC 888. In such a situation, if the liquidators of the insolvent company could hold the shareholder liable as a contributory and the courts held in their favour, then, there is an inference that there was an adequate consideration for the supply of such goods and services.

143 [1981]BCC 379
If what the court meant above was that a company could take goods on credit but that a shareholder cannot subscribe for calls through the provision of future goods and services, then this is against the Pareto Optimality argument. Based on this argument, where a company is permitted to subscribe for shares through the future supply of goods and services and the company is also allowed to acquire assets on credit, such a theory will only make some people better off without making any one worse off. In so doing, it can be deduced that the total welfare of the company and its members is increased rather than decreased.

7.3.1.2.3. Adequacy of Past or Future Consideration for Shares

Despite the conflicting rulings relating to the discharge of a specialty debt by future supply of goods and services, Anglo-Australian case and statute laws\(^{144}\) prohibit companies from accepting past or ‘future’ consideration in exchange for the issue of shares on the reasoning that the company has not come under any obligation to pay for such consideration\(^{145}\) or, as understood in law of contract, there is no connection between

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\(^{144}\) In the *Saxton's* case, above n 89, the court applying former s 56 of the *Companies Act 1958 (Vic)* as now amended by s 254X of the *Corporations Act 2001 (Cth)*, held a limited company could not allot shares on the basis than non-cash consideration, such as goodwill or services, be supplied at some future time. Interestingly, under Australian law, it is said in *Casey's Reid* that: “not all statements of services rendered are deemed past consideration” Is this consistent with its earlier position that past or future services are inadequate consideration? If not, when are ‘services rendered’ deemed to be adequate consideration? The law is silent.

\(^{145}\) *Companies Act 1985*, ss 99-116 and, 29 E C Directive, arts 1, 10 &29. Section 99(2) of the 1985 Act for example prohibits a public company from accepting in payment up of its shares, or any premium on them, an undertaking giving by any person that he/she or another person should do work or perform services for the company or any other person. A promoter also has no right against a company to payment for his promotion service in the absence of an express contract with the company. Such a contract will normally have to be under seal since the company cannot make a valid contract before incorporation and when the contract can be made the consideration by the promoter will normally be past. See for example, previous *Company Act 1867*, s 25 and the decision in *Re Eddystone Marine Insurance Co* [1893] 9 Ch 9. Cf with Scottish Law (especially, *Scott v Money Order Co Ltd* (1870) 42 Sc Jur 212). According to English law, if a company accepts past or future services in payment up of its shares, the holder of the shares is liable to pay in cash to the company in respect of those shares an amount equal to the amount treated as paid up by the undertaking together with interest. Section 115 of the 1985 Act further states that the enforceability for the undertaking is unaffected but that, it is open to a person who incur liability resulting from a contravention of the ban on such undertaking being good consideration to apply to the court for relied under s 113. Apart from the fact that Australian law does not distinguish between public and private companies when it concerns issues of non-cash consideration, a similar law applicable in the UK applies in our jurisdiction. Although our courts frowned at past consideration, there is however a statement in our law to the effect that, though a consideration was for example, “for services rendered”, does not necessarily mean the consideration was past: *Carew-Reid v Public Trustee* (1993) 12 ACSR 640, 643 per White J, *Re Casey's Patent; Steward v Casey* [1892] 1 Ch 104, 116 per Bowen LJ. With this nature of statements, we can easily predict difficulties in the construction as to what ‘past consideration’ refers to.
Chapter 7  7.3. Policy Problems (Adequacy of Past or Future Consideration)

the act and the promise, the promise is simply an expression of gratitude by the promisor.¹⁴⁶

Comparatively, that state of the law seems to be inconsistent with Scottish and American¹⁴⁷ law, where either past or future consideration is considered an adequate consideration.¹⁴⁸ In Park Business Interiors Ltd v Park,¹⁴⁹ a private company decided to turn itself into a public company. Before doing so it resolved to allot £6,000 fully paid shares to the existing directors and shareholders, and a contract was made agreeing to allot the shares in consideration of their past services and expenses in forming the company and establishing the business. The contract was registered and the shares were allotted. The company afterwards went into liquidation. The court held that there is no rule in Scots law that past services to the company could not constitute adequate consideration.

Similarly, in Scott v Money Order Co Etc Ltd¹⁵⁰, the promoter of a Scottish company might be entitled to recover, on a suitably worded provision in the company’s constitution, from the company payment made by him in connection with the formation of the company. His success against the company seems to depend on him/her establishing that the relevant provision creates a jus quaestium tertio in its favour. Where such a right is established a promoter is entitled to remuneration for professional services rendered.

¹⁴⁶ Hocker, Duffy and Haffey, Cases and Materials on Contracts, (5th ed, 1985) 97
¹⁴⁷ In the US, s 69 of the New York Stock Corporations Law is typical of one of the State Jurisdictions providing past or future consideration is adequate consideration for the issue of shares. The American Law Institute in its Restatement of the Law of Contract Chap 3, s 84(d), has declared that performance (or promise of performance) of a contractual duty owed to a third party is sufficient consideration. According to US approach, where business people are negotiating at arms length, justice requires that the parties, be held to their bargain unless it can be shown that the contract was vitiated by fraud, mistake or duress. (This view seems to be consistent with the common law decision of Re Wragg). Cf Herbert v Dunyes, 34 App Div 478(1898) where an early US court adopted the Anglo-Australian negative approach stating:

The Statutes requires that stock shall be paid for either by cash or property. Services rendered in bringing a corporation into existence are neither cash nor property. If it were, then the entire capital stock could thus be disposed of, and the only asset which the corporation would have would be its naked existence.

In Canada, s 25(3) of the Canadian Business Corporations Act (CBCA) provides that, shares shall not be issued as fully paid until the consideration is paid in money or money’s worth (including past services) that is not less in value, to the fair equivalent value of the money that the corporation would have received if the shares had been issued for cash.

¹⁴⁸ See also Zoutpanzberg Prospecting Co [1891] 1 Ch 119.
¹⁴⁹ [1990]BCC 914.
¹⁵⁰ (1870) 42 SC Jur 212. See also, Edinburg Northern Tramway Co v Mann (1896)23 R 1056.
Chapter 7

7.3. Policy Problems (Adequacy of Past or Future Consideration)

If no such right is established, neither promoters nor experts employed by them have a right of remuneration from the new company.\textsuperscript{151} The question is when is a consideration 'past', and does past consideration reflect an inadequate consideration? Should the Scottish and American position be adopted?

In general, if the decision in Re Wragg and other cases supporting it are to be followed, it may be possible that any tension between the imperative to maintain capital (for the protection of creditors) and the possible abuse of the power to issue shares in return for money's worth rather than money, will be resolved by permitting shareholders to rely on the contract made for the issue of shares in all but very few cases. Indeed, it may be thought that resolution in this way was inevitable once the Salomon case was decided and full effect was given to the separate legal personality of the corporation and the limited liability of its corporators.

There is, however, a latent ambiguity in the use of the words 'past consideration'. The distinction between past or future consideration can simply be illustrated: Suppose [A] performs some act which benefits [B] without any request from [B], and [B] subsequently promises to pay [A]. The courts have refused to enforce the promise because there is no consideration to support it. Conceivably, this rule can have very important implications in commercial contracts where some of the undertakings given by the parties are part of the contract but others are given after the agreement has been made and are therefore unenforceable.\textsuperscript{152} Whether a consideration is 'past' or 'future' will depend on the circumstances surrounding the agreement or contract entered between the parties. Obviously, past consideration, if it did not give rise to a liability when it was performed, so far from being consideration received for the promise, may be considered merely gratuitous.

There is no reason for making this gratuitous promise binding unless we are willing to inquire into the promisor's motive. As the law now stands, the only consideration which

\textsuperscript{151} Cf. Robertson v Beaton [1908] SC 921, 928.

\textsuperscript{152} Roscola v Thomas (1842) 3 QB 234; Casey v Cnr of Inland Revenue [1959] NZLR 1052.
can conceivably be called past and which is recognized as valid is an act done at the request of another in circumstances which justify the actor in expecting a reward, but without the amount of the reward being ascertained between the parties. The actor in such a case is entitled upon a quantum meruit to recover a reasonable amount. The rule in question is now simply that in such a case if the person who requested that act subsequently promises a liquidated amount by way of reward for that act, the sum so promised is as against the promisor’s evidence (and probably conclusive evidence) of at any rate the minimum value of the service rendered at his request.\(^{153}\)

What ever the situation may be, any attempt to adopt Re Wragg would imply adopting s 25 of the 1867 Act (UK)\(^{154}\) which in recent times, serves no useful purpose. The decisions that follow Re Wragg, introducing the rule that no inquiry may be made into the adequacy of consideration unless the contract itself can be impeached, is clearly against the interests of creditors for, it has always proved difficult to impeach a contract of subscription. The potential harm caused to creditors by the impeachment rule was pointed to by Stuart V-C in Leekes case.\(^{155}\) The V-Chancellor, in a particularly lucid judgment, said:

In the case of Forbes & Judd,\(^{156}\) the Lord Chancellor ... used this remarkable expression: “As to hardship to the creditors of the company, there is none, for they get the property instead of the money.” That might be true, if the property was worth as much to the creditor as the money, or if the creditors agreed to take it instead of money. But all experience shows that the sort of property given in such cases is for the most part worthless, and often worse than any real value. Indeed, the worthlessness of the property which is the subject of such agreements is the real reason why they are made... The Act of Parliament is a statutory contract with the creditors. It limits the rights of creditors to a certain amount to be subscribed in money. If the creditors are not parties to an alteration of this contract, and if by an agreement among the shareholders, who are the debtors, without the consent of the creditors, they arrange to give property (where the thing deserves the

\(^{153}\) It is importantly noteworthy that ‘past’ or ‘future’ consideration is a technical issue which conflicts with the rules of evidence, rules of contract law and those of corporations law (see, for example, C. J. Hamson, ‘The Reform of Consideration’ (1938)124 LQR 233, 252). Another justification that past consideration should be sufficient consideration is to draw analogy from rules governing issue of bills of exchange. A bill, is no doubt, enforceable if it is issued in respect of an antecedent debt or liability.

\(^{154}\) As earlier seen, s 25 requires the contract to be sealed in writing and unless it is impeached by fraud, the contract is binding on the parties (known as the “impeachment rule”).

\(^{155}\) In Re Empire Association Corporation (“Leekes case”) (1871) LR 11 Eq 107

\(^{156}\) In Re Heyford Iron Works Co (Forbes & Judd case”) (1870) LR 5 Ch 273
name of property) for the capital instead of money, and the worth of the property is to be taken at
the estimate of the debtor, without any agreement by the creditor, and this is to be forced on the
creditor without giving him any right to inquire as to value, there is no bound to be fraud which
may be practiced on creditors and honest shareholders.\footnote{157}

The above decision clearly emphasizes the mistaken logic of \textit{Re Wragg} and the
impeachment rule. In refusing to follow it, the Vice-Chancellor was correctly seeking to
maintain the integrity of share capital as a guarantee fund for the protection of creditors.
In this writer's opinion, the decision in \textit{Leekes} and \textit{Re Eddystone} should be followed
since they predate the decision in \textit{Trevor v Whitworth}.\footnote{158} This submission is also
premised on the fact that attempts to demonstrate that an agreement to issue shares in
return for payment in kind rather than cash should be set aside as colorable or illusory
have not often succeeded.\footnote{159} The above submission aside, where 'past or future services'
could generate some commercial advantages to the welfare of the company, should such
consideration be regarded as adequate for purposes of the legal capital doctrine. There is
comparable support that past or future consideration is good consideration. This can be
done with a simple example: Suppose, however that the promoter is allotted shares not
for bringing the corporation into existence but for remaining with the company after it has
reached the going concern stage. What is the position of the law?

\footnote{157} (1871) LR 11 Eq 107.
\footnote{158} (1897) 12 App Cas 415.
\footnote{159} For example, see, \textit{Chapman's case}, above n 87; \textit{In re Innes & Co Ltd} [1903] 2 Ch 254; \textit{Hong Kong & China Gas
Co Ltd v Glen} [1914] 1 Ch 527. One case in which the attempt did succeed is in \textit{Re White Star Line Ltd} [1938] Ch
458. There, more than 1.5 million shares had been issued by White Star, Ltd to Royal Mail Steam Packet Company.
The shares were partly paid, a total of £750,990 having been called but not paid. The issuing company (White
Star) then agreed to accept from the Royal Mail Co Deferred Creditors Certificates for the nominal amount of the
debt due on the shares. It was acknowledged in evidence that, at all material times the certificates were to the
knowledge of both parties, worth a great deal less than their nominal value. It was not found, however, that the
certificates were entirely worthless. There was therefore consideration sufficient to support an accord and
satisfaction. Nevertheless, the Court of Appeal held that the shareholder was to be treated as the holder of the
shares on which £750,990 remained unpaid. It held that money's worth was not given, or to use alternative
language, that the consideration was colorable and illusory in so far as it was represented as being of the value of
£750,990. The actual decision in \textit{Re White Star} may be understood as turning on the fact that both parties to the
transaction knew that the consideration offered and received was not worth the sum attributed to it. Such a case
has obvious parallels with the kind of equitable fraud identified by Lord Hardwick in \textit{Chesterfield v
Jansen} [1750] 2 Ves sen 125 [28 ER 82] where the nature and circumstances of the transaction reveal it to be 'an
imposition and deceit on the other persons not parties to the fraudulent agreement'. Perhaps, the only legislative
protection from illusory non cash consideration is to adopt the contemporary independent expert valuation,
reinforced by the disclosure provisions of the \textit{Corporations Act} \textit{s 254X} which is to effect that, companies issuing
non cash shares under a contract be required to comply to a statutory disclosure. Those companies (public
companies) are required to lodge such a statutory notice with ASIC. The purpose, being to enable persons
searching the public records to confirm that the consideration provided for shares is not less than would have
been the cash liability for them. However, the effectiveness of that section is open to doubts since it applies only
to public companies.
In the US case of *Wellington Bull & Co Inc v Morris*\(^{160}\), the company was formed pursuant to Morris' idea to organize Morris plan banks. The defendant (Morris) was essential to the continued life of the company, in the unanimous opinion of directors and shareholders. Should a defendant in a Morris-type situation be allowed to retain his added share compensation in the face of statutes allowing services rendered but prohibiting past or future consideration? Morris had not given any money or property or done any labour in the usual sense of those terms. The court held that the extra compensation could not be past service.

Curiously enough, Morris was part and parcel of the company. With his continued services the venture might have succeeded; without him the plan was practically assured of failure. Could it not be argued in a common vein, then, that the agreement under which the directors 'induced' Morris to remain with the organization amounted to 'property actually received (or, services rendered?). The conclusion seemed inescapable that Morris' continued services were as much, if not more, of an asset to the corporation as physical equipment such as plant or machinery. It is submitted that the courts did not wish to strike down such an arrangement as void for lack of adequate consideration merely because the requirements of the non-cash consideration (such as money, labour done, or property actually received) portions of the statutes were not technically fulfilled.

\[^{160}\text{230 N.Y.Supp 122 (1928). As a further illustration, suppose the 'past consideration' was a part of an agreed exchange at the time when it was conferred? The US case of Griffin v Louisville Trust Co, 312 Ky 145 (1930) is illustrative. There, an employer promised to pay the employee, in recognition of long service, a bonus or pension. Although the employer's promise is 'gratuitous' in the sense that no present consideration is given in exchange, yet the employer's payment is in effect a deferred compensation. (Let's substitute the 'employer' as a company and the 'employee' as a shareholder for purposes of our discussion). If the shareholder renders no service after the promise is made (and fails to prove a substantial change in position in reliance), the promise is a sham. It is arguable that to hold the company liable on such a promise long after it has sold the goods and services (to which the shareholder contributed) at prices that did not include a pension contribution is to make the company much poorer. On the other hand, it can be argued that the shareholder and the company came into an agreement whereby the shareholder preferred to take shares in the company as consideration for the payment of the compensation by the company. Should this be an inadequate consideration? The courts could not see how such a contract could not be enforceable on each party. (Refer to, E D Patterson, "An Apology for Consideration" (1958) 58 Cal LR 929, 956). The cases are illustrative that it is not in all situations (whether in contract or company laws), that a past consideration may not lead to adequate consideration.}\]
Chapter 7

7.3. Policy Problems (Adequacy of Past or Future Consideration)

The force of the above argument is also consistent with the view that, in the ‘new economy’, ideas are increasingly worth more than physical assets.\(^{161}\) Therefore, if past or future services are prohibited, this unduly curtails the ability of existing companies to customize compensation packages to recruit and retain talented employees. This view is also consistent with §6.21(b) of the U.S “RMBC Act” which allows companies to issue shares for consideration consisting\(^{162}\) of intangible property or benefits and ‘contracts for services to be performed’. The argument is that, if companies could issue shares in exchange for future services, start up companies would benefit most. In the first year of their operation, such companies usually have little cash but great need for the services of experts such as lawyers, accountants and management consultants on an ongoing-basis.

The typical ratio of market capitalization (a realizable estimate of the ‘true’ value of a company), to book value is much higher today than in the past because, ideas now account for profitability more than real assets do. The prohibition under Anglo-Australian law against issuing shares in exchange of future services also generates obvious problems for the financing of high-tech start-up companies. As earlier indicated, ideas play an important role in both equity and debt financing and competitors strive to retain the best minds. It is crucial therefore for business to attract the best thinkers in order to succeed in the new economic era.\(^{163}\) Though the idea that past or future consideration appears to be moribund in our jurisdiction, it may be premature to assume that it has been buried. Therefore, as long as there is adequate valuation (i.e., ‘expert valuation’) of past or future consideration, and its value can be easily determinable to be equivalent to the issue price of the shares that should be sufficient consideration to release a shareholder from liability.


7.3. Policy Problems (Cross Payments & Set-Off)

7.3.1.2.4. Extinction of Liability by Cross-payments & Set-Off

In an earlier statement, it was indicated that s 254X contains the only legislative protection from illusory non cash consideration. However, this limited protection can be nullified if the shareholder and the company utilize an off-setting transaction. Such an arrangement has long been held since Spargo’s case, as means of discharging a ‘cash’ liability. There, Spargo took shares in a company which was formed to purchase his tin and copper mine. The whole nominal amount of the shares was immediately payable, as was the purchase price of the mine. It was agreed between Spargo and the company that he should be credited in account with the price of the mine, and debited with the amount payable on the shares. The balance of the account remained in debit and this was made good by way of cash payment. Shortly afterwards, the company went into liquidation and the liquidator sought to recover from Spargo the sum of £2, 176, being the non cash component of his shares (i.e., the value attributed to the mine). In doing so, the liquidator did not claim that the mine had been overvalued, he instead sought to rely on the fact that no memorandum had been registered pursuant to section 25 of the Companies Act 1867 (UK). As such, he argued, Spargo must now make good the payment in cash. Fry Q.C. for the liquidator said:

We contend that under the Act of 1867 Spargo is liable on all the shares he took, no memorandum such as is required by the act having been registered. The Act requires that if there be no such memorandum the shares shall be paid up in cash.

Given the terms of section 25, Fry Q.C. may have been right in his contention, and the only course open to the court (if it was to ensure that Spargo did not pay twice for his shares) was to hold that the issue of shares was for cash and, accordingly, not in need of registration. This was the course adopted. As Lord Justice James put it:

But if a transaction resulted in this, that there was on one side a bona fide debt payable in money at once from the purchase of property and on the other side a bona fide liability to pay money at once on shares, so that if bank notes had been handed from one side of the table to the other in

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164 Re Harmony & Montague Tin & Copper Mining Co, (Spargo’s case) (1873)LR 8 Ch App 407. For purposes of this study, the writer will repeatedly refer to the case as either the “Spargo’s case” or the Spargo doctrine.
payment of calls, they might legitimately have been handed back in payment for the property... This Act of Parliament did not make it necessary that the formality should be gone through of the money being handed over and taken back again; but that if the two demands are set off against each other the shares have been paid for in cash. If it came to this, that there was a debt in money payable immediately by the company to the shareholders, and an equal debt payable immediately by the shareholders to the company, the company could have pleaded payment in action brought against it, and the shareholder could have pleaded payment in cash in a corresponding action brought by the company against him for calls. Supposing the transaction to be an honest transaction, it would be in court of law sufficient evidence in support of a plea of payment in cash.¹⁶⁶

Similarly, Lord Justice Melish said:

In the present case, I am of opinion that if an action were brought at law for the amount originally payable on these shares, there would be a valid defense, under a plea of payment. Nothing is clearer than that if parties account with each other, and sums are stated to be due on one side, and sums to an equal amount due on the other side on that account, and those accounts are settled by both parties, it is exactly the same thing as if the sum due on both sides had been paid.¹⁶⁷

The rule created by the Spargo's case clearly had the effect of alleviating the harshness of section 25 of the English Company Act of 1867. While the 1867 Act has gone Spargo's case remains to create uncertainty in the current Anglo-Australian law. The questions in issue are:

- What do the Anglo-Australian courts say about the "Spargo doctrine returned to account"?
- Should shareholders use 'set-off' as a spring board to extinguish their liability to the company? (Alternatively, is cash-off-setting an adequate consideration for the issue of shares?);
- What ramifications does this have on creditors and the capital maintenance doctrine?

Surprisingly, while the 'Spargo doctrine' is deeply entrenched in Anglo-Australian law, neither the courts nor legislature in these jurisdictions have faced the issues involved in cash-off setting with any consistent awareness of the dangers or merits which this doctrine poses for shareholders and creditors. While s 553C¹⁶⁸ regulates any set-off which

¹⁶⁵ Ibid, at 410, 428.
¹⁶⁶ Ibid 415
¹⁶⁷ Ibid 415-417.
¹⁶⁸ Section 553C is reinforced by 254X with respect to public companies.
Chapter 7  7.3. Policy Problems (Cross Payments & Set-Off)

can be claimed in an insolvency, but only vis-à-vis the insolvent company and the person with the claim against the company. The bare wording of s 553C itself does not allow for insolvency set-off between any parties other than the insolvent company and the entity claming against it. Section 553C (1) provides:

Subject to subsection (2), where there have been mutual debts or other mutual dealings between an insolvent company that is being wound-up and a person who wants to have a debt or claim admitted against the company:

(a) an account is to be taken of what is due from the one party to the other in respect of those mutual dealings; and
(b) the sum due from one party is to be set off against any sum due from the other part; and
(c) Only the balance of the account is admissible to proof against the company, or is payable to the company, as the case may be.

(2) A person is not entitled under this section to claim the benefit of a set-off if, at the time of given credit to the company, or at the time of receiving credit from the company, the person had notice of the fact that the company was insolvent

Although, it may be assumed that the Corporations Act acknowledges set-off as a method by which parties to a transaction could extinguish their liabilities, off-setting is more of an issue in the United Kingdom which retains par value. Some commentators have argued that the decision in Spargo's case was wholly actuated by the draconian nature of section 25 of the English Companies Act 1867. Its relevancy during that period had the effect of alleviating the harshness of s 25 but, with section 25 long by-gone, continuous acceptance of the ‘Spargo doctrine’ may lead to abuse of certain provisions of the Corporations Act.\(^{169}\)

\(^{169}\) Refer, for example, to the Fifth Interim Report by the Company Law Advisory Committee to the Standing Committee of Attorney General ("Egglinton Report") (1971) para 10; Professor Gower, when chairing the Committee in drafting The Ghanaian Companies Code 1961, also recognized the abuses laid open by the Spargo's case. As a result, section 45 of that jurisdiction's Code was implemented to overcome the decision. Section 45 reads as follows:

Shares shall not be deemed to have been paid for in cash except to the extent that the company shall have received cash, therefore at the time of, or subsequently to, the agreement to issue the shares, and where shares are issued to a person who has sold or agreed to sell property or rendered or to persons nominated by him the amount of any payment made for the property or services shall be deducted from the amount of any cash payment made for the shares and only the balance (if any) shall be treated as having been paid in cash for such shares notwithstanding any exchange of cheques or securities for money.
The courts are equally divided in opinion as to whether a shareholder could discharge its liability to the company by set-off. The question of whether set-off provides valuable consideration may be problematic. However, as an examination of the cases in both corporate and contract laws will show, although, at least, to some extent set-off may be used to ‘abuse’ certain provisions of the law, in general, it can be argued that ‘set-off’ (in this case, insolvency set-off) is an appropriate means by which parties to a contract or agreement may extinguish their liability to each other.

The first judicial consideration of the question involved with cash-off setting in Australian law, after Spargo’s case, may be attributed, to Saxton’s decision. In this case, Alex Charles Saxton, who died, on 30th September 1926, was managing director for life of a company called ‘A.C Saxton & Sons Ltd.’ According to the company’s articles of association he had an unfettered authority over its affairs. The books of the company contained ‘advanced accounts’ in the name of his wife, his daughter and each of his five sons. According to these accounts, as balanced to 31st May 1925, his wife, his daughter and four sons were indebted to the company in sums together of £27, 098 2s 7d. The deceased himself also had an account in the company’s books. On the 7th of September 1925, he caused this account to be debited with the sum of £27, 098 2s 7d; for which he took the company’s cheque. He paid this cheque into his bank account, upon which he drew his own cheque for a corresponding total amount. These were paid to the company either directly by him or through his children. Simply put, the company owed its

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170 See, for example, the views expressed by Young J in, Re Jarass, above n 133. Cf with those of Fullagar J in Pro Image, above n 133. See generally, the inconsistencies in the authorities cited above, notes 132-134.

171 (1929) 43 CLR 247, 264. Two legal issues were involved here. One concerned the adequacy of the consideration for future supply of goods and services, and the second involved the question of set-off of mutual debts. It is to be noted that before then, Lord Halsbury LC, in Re Johannesburg Hotel [1891] 1 Ch 119 held that there can never be any cross-debts between the company and its allottees under a contract to take fully paid up shares, and, consequently, no payment can be effected by accepting the extinction of one debt as to the satisfaction of the other. Perhaps to give effect to the now repealed s 25 of the 1867 Companies Act. Halsbury LC must have thought that cross-payments would breach that Act and creditors whom the Act was assumed to protect would be prejudiced. With respect, the above logic appears indefensible. Clearly, s 25 was intended to offer creditors some protection from non cash consideration. But, for the courts to then assume (in the absence of clear legislative direction) that it was to be the only protection offends both traditional rules of statutory interpretation and good sense. While Re Johannesburg has never been judicially discussed in Australia, it is this writer’s opinion, that it would not be followed by Australian Courts.
shareholders and the shareholders also owed the company. The question for consideration was whether both liabilities could be discharged by set-off.

After hearing the relevant parties to the suit, the Supreme Court of (NSW), citing Spargo's case, and, quoting Mellish LJ said:

Nothing is clearer than that if parties account with each other, and sums are stated to be due on one side, and sums to an equal amount on the other side of that account, and those accounts are settled by both parties, it is exactly the same thing as if the sums due on both sides had been paid. Indeed, it is a general rule of law, that in every case where a transaction resolves itself into paying money by [A] to [B], and then handling it back again by [B] to [A], if the parties meet together and agree to set one demand against the other, they need not go through the form and ceremony of handling the money backward and forward.

The court, citing s 25 of the 1867 Act held that, in the absence of a filed agreement providing for some other form of payment, shares must be paid up in cash. It is, of course, well settled that when the liability upon shares and the liability upon a cross demand against the company of a sum certain and immediately payable are mutually extinguished by an agreed set-off, this amounts to payment within s 25. The court added that these principles (concerning set-off) are called into play only for purposes of s 25, and only where there is a sum lawfully payable by the company which when paid might lawfully be repaid to the company in discharge of the liability upon the shares. The liability upon shares cannot be discharged unless the company obtains in funds or assets that are a real equivalent to the capital represented by the shares. Thus, although an agreed extinguishment by set-off of the liability of the shareholder to the company and of the company’s liability to him is undoubtedly payment, yet, probably it is not competent to a company to incur a voluntary liability for the purpose of enabling such a set-off to be had.

172 (1873) 8 Ch App 407, 414.
173 Ibid.
174 This was in force as s 55 of the New South Wales Companies Act 1899.
175 See, Laroque v Beauchesnain [1897] AC 358, 365. There, Lord Macnaghten, applying the doctrine of Spargo's case, pointed to the necessity of independent agreements, each requiring an immediate payment of money down, in order that the setting off of the two demands should amount to payment in cash.
176 This statement is to effect that although Australian law considers set-off to be a reasonable vehicle by which parties could discharge their liability to each other, it however seeks to avoid a situation where parties could for
If the court meant that set-off was not possible, then to my reasoning, the court must have erred. It is the writer's view that the correctness of the decision in Spargo's case has never been doubted and it is clear from that case that, where there are mutual dealings and mutual debts, the circuity involved in actual cross-payments is dispensed with.\textsuperscript{177} Despite the view that Saxton's case was to be treated as similar to the Spargo ruling, a ruling that must have formed part of the Australian common law, the courts, were not yet decided as to whether Spargo's case should form the dominant rule in Australia.

The Spargo doctrine was however questioned in Re Jarass Pty Ltd.\textsuperscript{178} There, as part of a scheme of arrangement, certain unsecured creditors of an insolvent company agreed their debts would be extinguished by the company issuing shares to them of an equivalent nominal value. No money changed hands. The issue there was whether such an arrangement constitutes issuing shares at a discount which was prohibited under s 118(2) (a) (ii) of the Companies Act 1981 (as amended), unless confirmed by order of Court. According to creditors of Jarass Pty Ltd (The Company), the arrangement was not an issue of shares but rather an allotment of shares for full consideration other than cash—such as the forgiveness of the debt.

\textsuperscript{177} The following cases were directed to the application of s 25 of the principles of common law which enabled payment to be effected without circuitry: Fothergill's case (1873) 8 Ch App 270; North Sydney Investment & Tramway Co v Higgins (1899) AC 263; Famatina Development Corp Ltd v Bary [1910] AC 439, 442. The Insolvent Debtors Relief Act 1738, s 13 (8 Geo 1 c 22) (UK), provided for limited rights of set off as a procedural means of avoiding circuit of action.

\textsuperscript{178} (1983) 6 ACLC 769. Obviously, it may be difficult to follow Young J's ruling in the sense where there is a valid contract between the parties which is not tainted or colorable by deception and there is some commercial reason for procuring such a payment. The view is that the value of the debts may equal the nominal value of the shares that were issued therefore, whether the company paid cash to discharge the debt or any agreed figure in the contract between the parties, there is little need to inquire into adequacy of the consideration, and it may also be difficult to say such a scheme involves issuing shares at a discount. The decision in Pro Image is therefore the better to adopt. Consider also, FCT v Steves, Agnew & Co (Vic) Pty Ltd (1951) 82 CLR 408 at 420-421, where Dixon J said: 'if cross-liabilities in sum certain of equal amounts immediately payable are mutually extinguished by an agreed set-off, that amounts to payment for most common law and statutory purposes....'
Chapter 7  
7.3. Policy Problems (Cross Payments & Set-Off)

The lawyers for the company, citing Fadden v FCT\textsuperscript{79} said, if a company owes a creditor a dollar and the creditor then applies for a share in the company and proffers a dollar, it is appropriate for there to be a set-off of the two amounts. Despite the reasoning here, Young J, being guided by some English precedents,\textsuperscript{180} held that such a scheme did involve issuing shares at a discount because, the arrangement was an issue of shares not an allotment of shares for full consideration. The Judge further intimated that an offsetting transaction was only possible if the allotting company had an existing capacity to pay the relevant debts in cash.

Notwithstanding Young J’s ruling above, the decision was further considered in Pro Image Studios Ltd v Commonwealth Bank of Australia.\textsuperscript{181} This case which arose by reason of Young J in Re Jarass, was an application for a declaration as to whether a particular transaction led to an issue of shares at a discount within the meaning of s 190 of the “CL”. Fullagar J, refusing to follow the ruling in Re Jarass held that, where a debt was immediately due and payable, the issue of shares in consideration of the extinguishment of a debt due of a sum equal to the nominal value of the shares was not an issue at a discount. It was an issue for a payment in cash by set-off equal to the nominal value of the shares. He put it in the following way:

Where an insolvent company was released from debts arising to its unsecured creditors by allotting the creditors shares with a nominal value equivalent to the debt… a shareholder may, with the company’s consent off-set a debt owed by a company against a liability on the company’s shares even though the company has no present capacity to otherwise discharge the debt … It is the debt which is released that count, not some assessed value to the creditors of the debt owed to him based upon prospects of realization or execution of or upon the debts. Provided that the debt was genuinely created in the course of the company’s business … and provided that it is immediately

\textsuperscript{79} (1945) 7 ATD 533, 539. See also, “Pinnell’s case” [1774] All ER Rep 612.

\textsuperscript{180} Young J, cited authorities such as: Ooregum Gold Mining, above n 27; Re Johannesburg, above n 65; Goldsmith v Colonial Finance Mortgage Investment & Guarantee Corp Ltd (1909) 8 CLR 241, 248; Osborne v Steel Barrel Co Ltd [1942] 1 All ER 634, 638; Station Vanityon Commercial Investment Co Ltd (1983) 1 AC 501, 515. Also, quoting Cozens-Hardy LJ in Bellerby v Rowland & Marwood’s Steamship Co (1902) 2 Ch 14, 31-32 said:

“….The Ooregum case established that the company cannot by any device relieve a shareholder from the liability to pay the full amount due on its shares…”

In a similar vein, citing a NSW case: Clavarella v Balmen (1983) 2 NSWLR 439, 442 where it was held that an obligation to pay $1 is not extinguished by the mere fact that there is an obligation on the obligee to pay the obligor $1 also.
Chapter 7  

7.3. Policy Problems (Cross Payments & Set-Off)

... payable ... the issue of shares in consideration of the extinguishment of a debt of a sum equal to the nominal value of the shares issued is not an issue at a discount but is an issue for a payment in cash equivalent to the nominal value of the shares.\(^\text{182}\)

The above decision clearly emphasizes the inconsistent logic as to whether cash off-setting is an insufficient consideration for purposes of the issues of shares. In refusing to accept set-off as an adequate consideration, but an issue of shares at a discount, perhaps, Young J was correctly seeking to maintain the integrity of legal capital and the concept of limited liability for the protection of creditors.\(^\text{183}\) Despite the eloquent logic that may have influenced Young J’s decision, I am disposed to think that he was wrong to follow that course. What is ‘set-off’?

It is a debtor’s legally recognised right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. It is the reduction of an asset by a liability or of a liability by an asset recognizable at law or in equity.\(^\text{184}\)

Since a legally recognized right of set-off comprises rights of set-off that are recognized at law or in proceedings in equity, the conditions supporting the rights may vary from one jurisdiction to another and care must be taken to establish which law applies to the relationship. The existence of a right to set off an asset and a liability affects the rights and obligations associated with an asset and a liability and may affect significantly an entity’s exposure to credit and liquidity risk. However, the existence of the right, by itself,

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\(^\text{181}\) (1991) 4 ACSR 586, 588.

\(^\text{182}\) Ibid, Pro Image, was followed in FCT v Stovees, Agnew & Co (Vic) Pty Ltd (1951) 82 CLR 408, 420-421, Dixon J said: "If cross liabilities in sum certain of equal amounts immediately payable are mutually extinguished by an agreed set-off, that amounts to payment for most common law and statutory purposes ..." Also followed in Re Keth Bray Pty Ltd (1991) 5 ACSR 450. There, the plaintiff company was insolvent. As part of a scheme of arrangement, it was proposed that certain of the company’s debts be converted into equity by the issue of shares to the relevant creditors to a nominal value equal to the debt owing to those creditors in discharge of the debts. The court held that to consider such a transaction as issuing shares at a discount was unnecessary and inappropriate. The court held that set-off by arrangement does not depend on any statutory foundation and is in law, equivalent to actual payment on each side. The court proceeded on the basis that the conversion of debt into equity by an issue of shares at a nominal value equal to the amount of and in discharge of the debt, is a proper procedure to be undertaken by an insolvent company without any need of the court confirmation. See also, Collins v Collins (1984) 9 ACLR 58.

\(^\text{183}\) See, Trevor v Whitworth (1887) 12 App Cas 405.

\(^\text{184}\) Australian Accounting Standard Board (“AASB”) 1014, ‘Set-Off and Extinguishament of Debt’ [12 Dec, 1996] Commonwealth of Australian Gazette, Australian Accounting Research Foundation. Alternatively, set-off can be defined as a form of countervailing (opposing) claim which is made by one person[B] against another[A] where [A] has made a claim on [B]. It can arise in litigation or, in non litigation context, such as insolvency.
is not a sufficient basis for setting off. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future flows are not affected. Set off may remove the foundation on which a creditor’s petition or winding-up application is based. A right of set off in respect of a genuine and substantive countervailing claim may in effect extinguish the originating creditor’s debts or reduce it below the jurisdictional threshold, and thus, indicate that there has been no failure to pay the debt.\(^{185}\)

The better view is to adopt the approach taken by Fullagar J which has long been supported by the *Spargo case*. The justification is that so long as there are mutual debts\(^ {186}\) and, the value of the debts equals the nominal value of the shares and, since it can be impossible that the bankrupt (be it a company, or shareholder) would be capable to pay for its shares in ‘money’ or ‘liquid cash’, to fully discharge the debt, there is no reason to suggest that where in such a share issue transaction, if two existing cash liabilities (one owing by the company and one by the shareholder), can not be off-set.\(^ {187}\)

In Anglo-Australian law,\(^ {188}\) shares are issued for ‘cash’, which includes payments by a cheque received by the company in good-faith, the release of a liability of the company for a defined sum- 'set-off'.\(^ {189}\) If cash is construed in this sense, it thus preserves the

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\(^{185}\) *Westwind Air Charter Pty Ltd v Hawk Or Do Havilland Ltd* (1990) 3 WAR 71 (per) Dixon J.

\(^{186}\) Under the Bankruptcy Act 1966 (Cth) s 86 and under the Corporations Act 2001 (Cth) s 553(c), there is no right of set off in insolvency without mutuality. That section provides:

Subject to subsection(2), where there have been mutual debts or other mutual dealings between an insolvent company that is being wound-up and a person who wants to have a debt or claim admitted against the company:

(a) an account is to be taken of what is due from one party to the other in respect of those mutual dealings; and

(b) the sum due from one part is to be set off against any sum due from the other party; and

(c) Only the balance of the account is admissible to proof against the company....

A far back as the Insolvent Debtors Relief Act 1728, s 13, it was similarly provided that:

Where there are mutual debts between the plaintiff and defendant, or if either party sue and be sued as executor or administrator, where these are mutual debts between either party, one debt may be set off against the other ....

\(^{187}\) Though a general principle of English law that shares cannot be issued at a discount, the technical nature of that principle will not suffice on the basis of the wider rule that a company cannot effectually release a shareholder from its liability, so long as there are mutual credits and mutual debts.

\(^{188}\) See s 102 of the Companies Act 1985 (UK) and s 553 of the Corporations Act.

\(^{189}\) For the definition of cash, see s 738(2) of the Companies Act 1985 (UK).
decision in *Spargo*’s case. The protection afforded to creditors and shareholders is not considered to be weakened in any way when cash off-setting is permitted. Instead, to a certain level, corporators are protected by the disclosure provisions of s 254X, which have strengthened the valuation process of non cash consideration.

### 7.3.1.2.5. Cash Off-Setting and the Capital Maintenance Doctrine

In the previous discussions, it was suggested that cash-offsetting was an adequate means by which corporators could each discharge their liabilities. It was also suggested that, the extinguishment of a specialty debt by the future supply of goods and services at least, to some extent, may be beneficial but that, it can also lead to undesirable consequences.

A fundamental policy of corporate finance law is that of maintenance of capital. The principle as already seen is that creditors dealing with the company should know that the share capital provided by shareholders is fully paid in and will remain in the company and only to be subordinated on liquidation to the claims of creditors. This policy affects set off in three ways:

- Shares should not be issued at a discount so that a set off by the subscriber of a cross claim less than the unpaid nominal amount of the shares is not lawful. In some cases, the consideration has to be valued to ensure that a non cash consideration is not undervalued so that the shares are not issued at a discount
- In certain cases, shares must be paid for in ‘cash’ and the question here is whether a set-off is payment in cash
- On liquidation, shareholders are liable to pay in the amount unpaid on the shares to satisfy the debts of the company. The policy is that these contributions should be paid in full without set-off. If these were not so, the shareholders who were owed money by the company would receive payment by virtue of set out of the funds intended to be available for *pari passu* distribution amongst the creditors.

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190 This is a view which has been adopted by our corporations law (s 553C and of which, I am of the opinion that it is the correct approach. It is also universally recognized in the laws of bankruptcy, contract and Equity). For a detailed discussion on set-off as a law on its own, see, for example: Philip R. Wood, *English and International Set-Off* (1989); Patrick Parkinson, *The Principles of Equity* (2nd ed) (2003) 1027; Dorham, ‘Recent Issues in Relation to Set-Off’ (1994) 68 ALJ 331, 339; D. Everett, “Multi-Party Set-Off Agreements” (1993) 4 J of Banking Fin Law & Practice 180, 182; Australian Accounting Standard Board (‘AASB’) 1014, ‘Set-Off and Extinguishment of Debts’ (12 Dec, 1996) Commonwealth of Australian Gazette, Australian Accounting Research Foundation.
In Australia, the 'no discount rule' has been abolished. However, problems of set-off are rife in the UK and other European Member States jurisdictions, where the 'no discount rule' is still strong. Generally, section 100 of the Companies Act 1985 (UK) provides that a company's shares shall not be allotted at a discount. This confirms the rule established by Ooregum Gold Mining,\textsuperscript{191} to the effect that, as a general rule the total consideration received by a company for its shares must not be less than the nominal amount or par value of the shares. If shares are issued for a discount, the allottee is liable to pay the company the discount plus a prescribed interest.\textsuperscript{192}

It follows that, if set-off is allowed, the nominal amount of the cross-claims owed by the company to the subscriber to be set-off must in any event not be less than the unpaid par value of the shares. Thus, a company cannot lawfully issue 1,000 £1 shares on the basis that the subscription price is set off against a debt owed by the company to the subscriber of £750. The shares would have been issued at a discount of £250, confirming Young J's argument in Re Jarass.\textsuperscript{193} While the soundness of the Ooregum decision has formed part of the common law,\textsuperscript{194} it is unclear if it will still be applicable with the repeal of the no discount rule. Is set-off, according to the no discount rule for purposes of the UK, inconsistent with the share capital doctrine? It will depend on the particular issue in question. Where there are two mutual claims (debts) and the value of the two debts equals the nominal value of the shares that were issued, there is no discount issue involved and therefore, there is sufficiency of consideration. But where the two debts are not of an

\textsuperscript{191} [1892] AC 125. That central rule to preserve legal capital was stated by Lord Watson thus:

The Act of 1852 (s 8(5)) requires that, in the case of a company limited by shares, the memorandum of association shall contain the amount of the capital with which it proposes to be registered, divided into shares of a certain fixed amount. It seems to me that the system thus created by which the shareholders liability is to be limited by the amount unpaid upon his shares, renders it impossible for the company to depart from that requirement and by any expedient to arrange with their shareholders that they shall not be liable for the amount unpaid on the shares ....

\textsuperscript{192} Companies Act 1985, s 100(2).

\textsuperscript{193} (1991) 4 ACSR 586. There, Higgins J said:

The law as to companies in New South Wales is the same, in all essential points, as the law of England, and it is to my mind clear that any agreement relieving a shareholder of his liability to pay calls would be an agreement for reduction of capital, and therefore void: Trevor v Whitworth (1887) 12 App Cas 405; Ooregum Gold Mining...

\textsuperscript{194} Gold Smith v Colonial Finance Ltd (1909) 8 CLR 241
equivalent value, then it can be right to say that the shares were issued at a discount and there was a reduction in the share capital of the company. Where a company issues debt security, such as negotiable bonds or unsecured debentures, which are convertible into shares, the amount of the security owed by the company is contractually set off against the subscription price for the shares. Hence, the issue of say, $100 bonds at a discount immediately convertible into fully paid $100 shares is unlawful, because, the company did not receive the full $100 on the bonds and thus, will not receive the full $100 on the issue of the shares on exercise of the conversion option. ⁹⁵ But, where a company issues $100 non-convertible debentures at $80 and then subsequently redeems the debentures of holders wishing to be redeemed and agrees to issue to those holders shares of $100 fully paid, this is not ordinarily an issue of shares at a discount. The reason is that there is no initial agreement obliging the company to issue $100 shares for $80 debentures immediately on issue.

7.4. Regulation & Valuation of Non-cash consideration for the issue of shares.

The judicial test for the valuation of property paid for shares involves a determination of the fair value of the (statutory) type of consideration. Generally, the rule is that if shareholders pay for their shares in money (cash), no problem of valuation arises except that of simple mathematical computation. Therefore, where the amount unpaid is clear, according to the principles of limited liability, the shareholder remains liable for the nominal value or issue price of the shares held until the company has received consideration which it genuinely believes is equivalent to that value. ⁹⁶

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⁹⁵ See, Mosely v Koffyfontein (No 1) [1904] 2Ch 108.
⁹⁶ Ooregum Gold Mining, above n 27; Re Almada & Tirio Co (1888) 38 Ch D 415, 423 per Cotton LJ dicta; Hong-Kong & China Gas Ltd v Glen [1914] 1Ch 527, 540 per Sargent J. According to case law, where a company fails to make a genuine attempt to value the consideration in exchange for its shares, the shareholder is liable to pay the full nominal value in 'cash: Re White Star Line Ltd[1938] 1 Ch 458. In Titin Exploration Syndicate Ltd v Sandy's[1947] 177 LT 412, the court held that a share allotment was void and illegal where it was obvious that the company had made no attempt to correlate the value of non-cash consideration with the nominal value of the issued shares. If this is the situation, one is forced to ask the question: Why should shareholders be liable to pay the full nominal value in cash when the contract for allotment was void and illegal. How can an illegal contract be enforceable? Is this not inconsistent with the law of contract? Moreover, why must shareholders pay for the full value when it was the company or its directors who manage the company failed to correlate the value for the non cash shares? The shareholder is simply a man of straw, although a 'businessperson, he/she is not imputed with the knowledge and duty of care required of the management of the company. All the shareholder knows is that they subscribe money or moneys worth for the allotment of the shares in the company. It is for the company or its directors to value such shares to ascertain if and whether the shareholder has paid for its shares fully or partly. If the directors or the company tell the shareholder, 'you have paid for your shares fully but it later happens that the
7.4. Valuation of Non-cash consideration

Serious problems and consequences may follow where the amount unpaid is unclear and, where the value involves shares of non-cash consideration. Though the courts contemplate that where the valuation involves non-cash consideration, the company should make an attempt to correlate such value with the non cash consideration, the courts provided no guidelines on how such a valuation should be attained.

In accordance with sections 103 & 108 of the *English Companies Act*, the preferred mode for valuation of non cash share issues is the ‘Independent Expert Valuation’ method. However, under Australian share capital provisions, the ‘Director’s Honest Estimate’ test (“Good-faith”) approach is followed. The difficult question for determination is to evaluate the two approaches to ascertain which provides the optimum standard for regulating non cash consideration.

### 7.4.1. The ‘Director’s Honest Estimate’ test (“Good faith rule”)

The Corporations Act, does not impose any statutory obligation on a company to obtain contemporary expert opinion. It rather adopts the traditional view taken by the common
law courts,\textsuperscript{202} that the directors, be left with the task of determining the value and adequacy of non cash consideration and, for them to state the basis of their valuation in a board resolution\textsuperscript{203}. How the company or its directors go about doing that, or arriving at a reasonable valuation is open to doubts. Most usually, it is for the company’s directors to satisfy themselves that the consideration fairly represents the amount due on the shares.\textsuperscript{204} The directors’ honest estimate test recognizes that value is a matter of opinion, not fact. If the property in question is valued in good faith, the shareholder is relieved from liability, even though the actual value of the property is shown to be less than that placed upon it. Typical statutes provide that:

\begin{quote}
...any corporation may purchase any property authorized by its certificate of incorporation and may issue shares to the amount of the value in payment therefore ...and in the absence of fraud in the transaction, the judgment of the directors shall be conclusive.\textsuperscript{205}
\end{quote}

In deciding whether to issue shares for non cash consideration, directors owe a fiduciary duty to apply their minds to the adequacy of the consideration.\textsuperscript{206} If the directors of a company fail to assess true money value of property received in exchange for shares, it is bad faith per se on their part. This proposition flows from the decision of Roxburg J in \textit{Tintin Exploration Syndicate Ltd v Sandys}.\textsuperscript{207} There, the company, which carried on mining activities in Western Africa, issued 13,500 shares to the defendants. The allotment was carried out on the broad footing that the defendants had expended uncalculated sums on the company’s property, but no money value was placed on the services rendered by the defendants or upon certain property transferred by the former to the latter. As such, no effort was made to correlate the value of the property and the services to the par value of

\textsuperscript{202} The common law has always adopted an aleatory view of the assessment of the value of the consideration received for an issue of shares (See for example, \textit{Re Wragg}).

\textsuperscript{203} \textit{C&SLRC Report}, above n 188. Cf \textit{ASX Listing Rule 9}, above n 200.


\textsuperscript{205} See, for example, the \textit{New Zealand Company Act} 1993, s 47; s 69 of the \textit{New York Stock Corporation Law}; \textit{Canadian Business Corporations Act} 1990, s 25(3); \textit{Revised Model Business Corporations Act} ("RMBCA") (US) para 6.21 (c) which requires directors to make a judgment on the adequacy of consideration which is conclusive when determining whether shares are ‘validly issued, fully paid, and non assessable’.

\textsuperscript{206} \textit{Park Business Interior Ltd v Park} [1992] BCLC 1034, 1040 per Lord Coulsfield.

\textsuperscript{207} (1947) 177 LT 412 at 418 per Roxburgh J. Contra, \textit{Re Baglan Hall Colliery Co} (1970) LR 5 Ch App 346.
the shares. In striking down the issue as unlawful, Roxburgh J repeated Lord Watson in 
_Ooregum Gold Mining:_

In the present case the company made no estimate. The company did not honestly regard, or regard at all, the consideration given as fairly representing the nominal value of the shares in cash. It is not a question of whether it was honest or not; it did not do it at all. In my judgment, this transaction was a colourable transaction within the meaning of that phrase as used by Lord Watson.208

Even though in the above case directors were held liable for not valuing the non cash share issues, the ‘director’s test’ is misleading.209 While it may not only be very difficult to impugn the directors’ valuation, the courts are equally reluctant to critically examine an honest valuation. The courts have often taken a ‘hands-off’ approach to second guess the actions of businessmen. The basic principle from which the courts work to determine the fairness of a share transaction was that, shareholders acting honestly are usually better judges of what is to their commercial advantage than the courts can be.210

Since directors lack the necessary expertise to adequately provide a reasonable but ‘nearer’ to proper value, there is a greater risk that they may arrive at a biased opinion since in most cases, they are also members of the company. They may also collude with the majority shareholders. Consequently, company’s creditors and members may be prejudiced by either a company’s directors’ overvaluation, i.e., directors have the ability

208 (1947) 177 LT 412 at 418.

209 The idea of using directors test through the ordinary principles of valuation involved difficulties which may produce artificial and unreal results. To support any assessment of non cash consideration by such a test is bound to mislead.

210 See, _Carruth v Imperial Chemical Industries_ [1937] AC 707; _Re Deniliquin Development Corporation Ltd_ (1994) 12 ACSR 627. These cases are illustrative to the fact that that in most cases, the courts will not bother themselves to ascertain if the valuation arrived at by the directors was sufficient not to prejudice either the creditors or other shareholders. At common law, despite stressing the importance of the maintenance of capital as a device for protecting creditors and shareholders, the courts were reluctant to examine the adequacy of non cash consideration for shares. In _Re Wragg Ltd_, the court said:

...Where a company allot shares in consideration for the acquisition of property...and, where the consideration which the company has agreed to accept as representing money’s worth, the nominal value of the shares be a consideration not clearly colorable nor illusory, then, in my judgment, the adequacy of the consideration cannot be impeached ... unless the contract can also be impeached; and I take it to be the law that it is not open to a [petitioner], unless he/she is able to impeach the agreement, to go into the adequacy of the consideration to show that the company have agreed to give an excessive value for what they purchased.
to dilute existing shareholder’s claims by allotting the vendor of the asset a disproportionately large stake in the capital of the company. The only constraints on such conduct (other than market constraints) are the directors’ fiduciary duties and duties of due diligence and, perhaps restrictions imposed by Australian Stock Exchange Listing rules. There are serious consequences that may follow an overvaluation of shares. The value for non-cash consideration may easily be abused by directors’ overvaluation giving rise to the overvalued shares. Since the public does not know the real value of the property exchange, when the company collapses, the shareholders lose their money and creditors are not paid. In some cases, the courts themselves have exposed the risks involved in the ‘director’s test.’

Since the courts are reluctant to second guess the bona fide judgment of directors in assessing the value of non-cash consideration, and in insisting on the presence of ‘actual fraud’ or ‘bad faith’ before the transaction can be inspected, the courts are taking an unrealistic view of the matter in place.

This process of overvaluation of non-cash consideration has been captivated in American jurisdictions as ‘stock watering’ (i.e., over-capitalisation which results from overstatement on the books of the company of the value of the capital assets). In Australia there are no adequate provisions to regulate stock watering by directors other than a simple liability for breach of duty of due diligence. This is an inadequate protection to creditors because of the existence of the business judgment rule and the difficulty of proving fraud. Even when the courts have attempted to provide a remedy, they attempt to punish violation of the law only after the offence of overvaluation and fraud has been committed. Cf the position in the US, where such ‘abuse’ is regulated by the so called “Blue-Sky-Laws”. There, the remedy is to regulate the issuing of non-cash shares before the issues are actually made. They are so called ‘blue sky-laws’ because they stop the sale of shares that represent nothing but blue sky (i.e., nothing terrestrial or tangible). The ‘blue sky law’ provides that no stock shall be sold unless its par value and its actual value correspond. Evidence in case law has shown that this remedy has done effective work in preventing the issuing of watered stock of both public and private companies. (See, for example, *Hall v Geiger-Jones Co.*, 242 U.S 539 (1917); *Caldwell v Sioux Falls Co.*, 242 US 559 (1917). (See, generally, J. C. Bonbright, “Dangers of Shares without Par” (1924) 24(5) Col LR 452, 453; W. W. Cook, “‘Watered Stock’-Commissions ‘Blue Sky Laws’-Stock without Par Value” (1921) 19 Mich LR 583, 583. Such a law also has its ramifications. While the passage of that law has been necessary to protect the public interest, it has delayed and embarrassed many legitimate enterprises. (J. H. Pou, “Shares of Stock without Par Value” (1922-23) 1 North Car LR 27. While the ‘blue sky law’ may have some significance, I would not recommend it be adopted in Australia, because, the notions of share capital and the capital maintenance doctrine are not deeply rooted in the US. However, if there was no other better alternative, it would have been a possible reform proposal. In *Hilder v Dexter*, Farewell J noted that, there is no rule of law requiring directors to issue new shares at their full market value; the issue price is a matter for the directors to determine in their unfettered discretion, which (subject to equitable doctrines of fiduciary duty) the courts will not second guess.

ASX Listing rule 9 as earlier indicated, deals with some forms of non-cash consideration for shares in listed Australian companies. See, also, ASX Listing Rules 7.1 which effectively gives shareholders veto rights in respect of significantly non-proportional share placements. (See, generally, *Shearer (Inspector of Taxes) v Bercaim Ltd* [1980] All ER 295. See, ASX Listing Rules 7.1 which effectively gives shareholders veto rights in respect of significantly non-proportional share placements.

Such overvalued (water stocks), deceives investors and induces them to buy shares or extend credit to the company on the supposition that the share capital had really been paid for at a certain issued price or, in money or money’s worth. Although the common law acknowledges that where there is overvaluation as a result of fraud, there can be a remedy of rescission for fraud, however, fraud is difficult to prove. (Cf *Anderson’s case* (1877) LR 7 Ch D 75 and the US case of, *Fogg v Blair*, 139 US 118 (1891)). The overvaluation of non cash shares by directors has been commented upon as “a deliberate invitation to faster tempo in the dishonest dance then known as ‘frenzied finance’” (J. C. Bonbright, above n 211, 450). (According to this commentator, what this nature of valuation denotes is that it stripped away from creditors their recourse against stockholders when actual
Chapter 7

7.4. Valuation of Non-cash consideration

One would have expected the judiciary and legislature to take some effective steps to prevent a company and its directors from issuing shares (or valuing them) for an overvalued consideration.\textsuperscript{215} Such overvaluation may mean that the company, while pretending to have increased the creditors guarantee fund by a stated amount (the nominal value of the shares issued) has, in fact, acted precisely as if the shares had been issued at a discount. The least one would have been entitled to look for is obviously a set of provisions giving the public ample opportunity of checking the basis of the valuation. Yet, those provisions in the Corporations Act which attempt to give a measure of publicity to this kind of transaction do not afford the outsider any knowledge as to how and why anyone could have arrived at the valuation placed upon those assets by the directors.\textsuperscript{216} How can a member of the public, say, a prospective creditor form an intelligent opinion of the commercial basis of the transaction? All creditors are given to understand is that non-cash consideration was transferred to the company by such and such a shareholder who got so many shares of such and such a nominal value in exchange.

How the valuation was arrived at remains a mystery. All the creditor may be told is that the directors honestly arrived at such a valuation. The s 254X(1)(e) proviso for public companies is no doubt a valuable source of information from the point of view of the

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\textsuperscript{215} See, 
\textsuperscript{216} The questionable nature of the director’s honest test, would have forced the courts to scrutinize the adequacy of the consideration and imposed upon judges and companies a far more positive task. We are not unfamiliar with the phenomenon that the courts have had to take upon themselves the burden of examining the adequacy of the consideration in contexts where questions of public policy were involved, either because they are forced to do so by statute, or because they themselves had to make the general principles of the law of contract yield to the unanswerable claims of a judicially recognized public policy: 
\textit{Clements v L.N.M Rly Co} [1894] 2 QB 482. But, in the case of contracts for the allotment of shares for non-monetary considerations, however, the courts fought shy of adapting the general doctrine of contract law to the needs of the situation. They found themselves paralysed by the magic of the doctrine that “consideration must be real but need not be adequate”: \textit{Re Wragg}. (Although, there are some exceptions, such as that if the company acts ‘dishonestly’, or ‘colorable’ or if the consideration is illusory, the contract will not stand. However, those exceptions are only applicable to the general principles of the law of contract. (Refer, for example to, \textit{Scott v Brown}, \textit{Doering & McNab Co} [1892] 2 QB 724.

Although this would be the case for private companies, since s 254X provides additional guarantees of publicity for public companies, there is still a question mark if that provision is effective enough. Section 254X is to effect that public companies using non-cash shares under s contract be required to a statutory disclosure notice’s 254X (1) (e)). This requires public companies to lodge such statutory notice with ASIC with the purpose to enable those searching the public records of a company to confirm that the consideration provided for shares is not less than would have been the cash liability for them.
prospective share/or debenture holder. Even the outside creditor may derive some benefit from the disclosure notice in that provision. Nevertheless, that provision does not satisfy the demand that the public should be in a position to scrutinize the basis of the directors' valuation of those assets which the company has acquired, or intends to acquire by the provision which compel a public company to publish an accountants report of a business to be acquired and paid for (partly or in full) out of the proceeds of an issue. An independent valuer is not called in to assess the bargain, as required in comparable contemporary jurisdictions. This absence of independent investigation into the adequacy of non cash consideration makes the director's honest valuation purely arbitrary. It is argued therefore, that, the task of examining the adequacy of non cash consideration is not one which either the company's directors or the courts should be asked to perform. The remedy of such a valuation cannot be found in a simple rule of director's test. It would be inopportune to leave this question on non cash valuation to the hazards of directors and litigation. Directors and judges cannot act as valuers and auditors, and they wisely refuse to do so, though their abstemiousness need not perhaps go as far as it did in cases like Re Wragg.

7.4.2. Independent Expert Valuation.

In the European Union Member States, it is mandatory for non-cash consideration to be valued by independent, expert persons. The Provisions of what is now sections 103 &108 of the English Companies Act 1985 requires an independent valuation of non cash consideration given in return for an allotment of shares in a public company. The 2nd EU Directive, Article 10, requires contributions in kind to be valued by an independent expert. It states:

A public company must not allot shares as fully or partly paid up (as to their nominal value) otherwise than in cash unless the consideration has been independently valued and a valuation.

\[\text{217} \text{ An 'independent expert' according to commentators in economics and financial milieu, is a person with proven experience in investment analysis who has publicly available information (Z.P. Matolesy, 'The Evaluation of Independent Experts Advice on Take-Over Offers: An Economics Finance Perspective' (1981) 10 ABLR 99, 100).}\]

\[\text{218} \text{ Inserted as s 103 (1) (a-b) of the Company's Act 1985 (UK).}\]
report has been made to the company in the next six months preceding the allotment. This requirement is relevant to private companies which are converting to public company status.219

The independent expert valuation requires one or more independent experts to create a report. The report, which the company must publish in accordance with article 10(3), must describe the assets and the methods of valuation, and indicate whether the resulting valuations 'correspond at least to the number and nominal value, or where there is no nominal value, to the accountable par, and where appropriate, to the premium on the shares to be issued for them.'220 To ensure an appropriate degree of independence, the expert is, in some cases, appointed by an administrative agency or court, and not by the relevant company. This reduces the chance that direct and indirect pressure may be successfully exerted on an expert to prepare a 'favourable' report.221

This independent valuation constitutes a safeguard against the founding shareholders inflating the value of their contribution, to the detriment of creditors. In comparative terms, this 'expert' approach, may remove some of the defects besetting the 'director's test.' The mystery of a lack of a valuation mechanism under the 'directors' test is removed. This method also provides a stringent mechanism which replaces the traditional reluctance of the courts from inquiring into the adequacy of the consideration. Though Australia does not adopt this English approach, many other areas of the Australian Corporations Act require an independent expert222 valuation for purposes of take-over and schemes of arrangement.223 If the Corporations Act could recognize the importance of an expert valuation in determining the fairness and reasonableness of the above transactions, why not adopt (apply) a similar approach for purposes of the valuation of non-cash consideration?

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219 See, also, 2nd EC Directive, above n 44 Articles 1, and 27.
220 Ibid, art 10 at 4. See also, Companies Act 1985, ss 103, 108.
221 See, Phosphate Co-op Co of Australia Ltd v Shears (No 3) [1989] VR 665 (in relation to how an expert's independence may be compromised).
222 The Australian Companies and Securities Law Reform Committee (C & SLRC), 'Issue of Shares for Non-cash Consideration and Treatment of Share Premiums' (September, 1986) para 10 rejected the contemporary independent expert procedure because, in its view, it would 'impose too costly a burden upon the commercial community.' The Committee was of the opinion that the better approach was for the directors to be obliged to state the basis of their valuation in a board resolution.
223 See, for example, Corporations Act, s 701 Compulsory acquisition procedures-in which following a takeover scheme, in response to which the target company is required to commission an independent expert report for its shares. See, also, Phosphate Co-op of Australia Ltd v Shears (No 3) [1989] VR 665.
Despite the overwhelming empirical evidence of market efficiency under an independent valuation in Australia and abroad,\(^{224}\) there are a number of commentators who question the validity of an independent valuation for the purpose of non-cash consideration. Matolcsy, for example, arguing from a take-over context, argues that an independent expert procedure is an unnecessary regulation of economic activity. This argument is based on the view that when the question of ‘whether to regulate as opposed to ‘how to’ regulate certain aspects of takeover activity is addressed, little or no justification and support can be found for an independent expert’s advice on takeover offers.\(^{225}\) This argument has no relevance to the current discussion so no comment will be made on it.

Another commentator, seems to have taken the view that an independent expert valuation for purposes of non-cash consideration seems to be unnecessarily complicated.\(^{226}\) This view was echoed by Harman J in *Re Ossory Estates plc*\(^ {227}\) where he described the provisions of s 108 as ‘curious and arcane’.\(^ {228}\) His Honour, continued in a seemingly similar critical vein,

They require a person, who is to be described as the valuer, to be entitled not to be the valuer, and to rely on some other valuer. They require the person to be independent but to be entitled to the auditor of the company … and they require various curious provisions as to what must be stated in the valuation report.\(^ {229}\)

It was also argued that, even if creditors do care about how much equity shareholders really injected into a venture at its outset, requiring an expert report on contributions in kind is of little benefit to them. This argument is premised on the notion that valuation techniques leave expert a very wide range of discretion.\(^ {230}\) The above criticisms notwithstanding, none of them is comparable to the general defects exposed in the directors’ honest estimate test above. The above critics, also assume uncritically the “director’s honest test”.


\(^{225}\) Matolcsy, above n 217, 99.


\(^{227}\) [1988] BCLC 213

\(^{228}\) Ibid, 215.

\(^{229}\) Ibid.
It is suggested that the better approach for valuing non-cash consideration is to adopt the contemporary expert valuation for non-cash share issues.

The independent valuation does not only provide a ‘nearer’ to proper valuation for non-cash issues, it removes another defect in the director’s honest estimate test—the overvaluation (“stock watering”) of the non-cash consideration. In practice, however, the requirement of independence is not particularly severe or, too costly as some may argue. For example, English Company law implementing this part of the second directive allows a company to appoint its current auditor or accountant as expert.\textsuperscript{231} Moreover, the independent expert valuation rules might be understood as responding to information asymmetries in markets for corporate credit by making it more likely that capital figures stated in a company’s public documents will actually have been represented by assets paid into the company by shareholders, further removing the problem of stock watering associated with the good faith test.

The independent experts are imposed with onerous duties of due diligence that go beyond that imposed by the Corporations Act. Experts are imputed with a high standard of caution and, where they knowingly or recklessly make any misleading, false or deceptive statement in response to a non-cash valuation, they suffer severe civil and criminal liability.\textsuperscript{232} Unlike the directors’ honest estimate test which relies on good faith and fraud, where in most cases, it is difficult to prove, directors are also exonerated from liability by way of the “business judgment rule”. This shifts all liability to shareholders and, inadequately protects creditors.

\textsuperscript{230} L. Bebchuk et al, ‘Fairness Opinions: How Fair are They?’ (1989)27 Duke LJ 29, 29-37. This commentator further takes the view that experts can never really be independent, even when a third party like a judge chooses the expert.

\textsuperscript{231} Refer to E. Ferran, Company Law and Corporate Finance, (1999) 298, 299. Cf. Italian position, where the judge (president of the local tribunal) appoints the expert (“Codice Commerciale” art 2343).

\textsuperscript{232} Companies Act 1985, s 110 imposes both fine and or imprisonment. Where the valuation requirements are not complied with, penal liabilities can attach to the allottee and also to subsequent holders of the shares. Even though the allottee may have duly conveyed assets of considerable value to the company, if the assets have not been duly valued, the allottee can still be required to pay again in cash, and to pay interest. This legislative policy is to prevent public companies from issuing shares at a discount. It may be difficult to subscribe to this sort of ‘double jeopardy’ type of penal liability on the allottee. The liability is harsh because, prima facie, allottees can be required to pay twice over, once in cash and once in moneys worth. Subsequent holders are also in what appears to be an invidious position because, they can be obliged to pay for the shares in cash even though the company may have already received from someone else, non-cash consideration in respect of them. However, this harshness
Although the independent expert valuation, it is submitted, is the preferred approach of providing an optimum valuation for non cash share issues, it is not free of problems in the sense that, since valuation of shares by experts is not an actual science, the argument that the procedure is cumbersome, and expensive thereby, generating high cost to the company may hold in certain cases, especially as it requires companies to retain professional valuers each time an issue of shares for non cash consideration is made. It can also be argued that expert valuation may delay company formation and increases the capital by requiring the company to pay for independent expert report. Another problem with the English independent expert valuation is that while only public companies face restrictions in the way it deals with non cash consideration, a private company does not generally face such constraints. Thus, a private company may by agreement, allot shares as fully paid or partly paid up otherwise than in cash in return for the transfer of property or the rendering of services to the company without an adequate valuation for the shares.

What ever the weaknesses of independent expert valuations, it is evident that the valuation of non cash consideration provided by independent experts would provide results which are 'nearer' to a proper valuation offered for non cash share issues than the result afforded by the directors' test. The various mechanisms used by experts to value non cash shares truly inform creditors and shareholders as to whether to invest in a limited company or, to provide it with credit. It is submitted that an optimum approach for valuing non cash consideration is to require both public and private companies to obtain contemporaneous, expert and genuine independent valuations. This should be reinforced by requirements similar but not identical to s 254X of the Corporations Act.

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233 One commentator take the view that in some cases, expert valuations add no value to the formation process. This is especially the case if the assets contributed have been fully and effectively valued at regular market prices. That, in case of listed or regularly traded securities being contributed, one could be doubtful of any expert valuation requirement if the assets can be valued on the basis of a price as determined in liquid and regularly functioning markets (see, "SLIM" Working Group, Company Law: Recommendations of the Simplification of the First and Second Company Law Directives (1999) 3, 4.

234 Another obvious difficulty with the independent valuation is that, since a very large proportion of shares issued in promoting a corporation are put out in payment for property, both tangible and intangible, there is the possibility of overvaluation by the independent experts. This is so in situations concerning valuation of real; estate and the appraisal of other properties due to the enormous divergence of the figures given by experts seemingly of equal experience (Refer to, Adams, "Valuation of Property paid for Stock: A Repraisal" (1948) 3 Miami LQ 26, 31).
7.5 Conclusion

These special rules as to independent expert valuation and disclosure should govern the allotment of shares. A reform proposal in Australian law to that effect,\(^{235}\) will usually call for valuation of the assets and disclosure of the results.

7.5. General Conclusion.

The current statutory requirements in Australian law relating to that which is given in exchange of shares issued by the corporation fail to adequately protect creditors and investors by failing to define adequately payments in money or money's worth. This lack of definition has forced the courts to give strained, and often unavoidably unjust, interpretations when faced with concrete problems of exchange. The courts in general have approached these problems at times with a realistic but also unrealistic attitude. Cross payments and cash off-setting may well be able to discharge a liability. Past or future consideration may be of greater value to the business than mere buildings and machinery. The current directors' honest estimate test is inadequate both in approach and application. A rule requiring in all cases contemporary independent expert valuation and full disclosure seems to be much suited to modern business practices and trends. In all, a statutory revision and progressive judicial thinking are still needed.

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\(^{235}\) A person who proposes to obtain an expert's report can have recourse to the s 667AA procedure, requesting ASIC in writing to nominate a person to prepare the expert report.
CHAPTER EIGHT
THE WAY FORWARD: RECOMMENDATIONS FOR OPTIMUM REGULATION & CREDITOR PROTECTION

8.1. Introduction

This chapter concludes the findings of the study. The aim is to present the future of the capital maintenance doctrine in the form of possible reform proposals. The recommendations shift from the traditional capital maintenance mechanisms to a solvency requirement and a debt-to-equity ratio as optimum means of regulating transactions affecting share capital.¹ The chapter further suggests that in addition to the specific proposals canvassed in each of the chapters of this study, creditor and shareholder protection would be maximized and reinforced by additional ‘fundamental safeguards’, such as the insolvent trading provisions, contractual covenants and the oppression remedy provisions.² Contrary to views expressed by commentators that the doctrine has outlived its purpose,³ for reasons provided in the proceeding section, it is not suggested that the doctrine be abolished. However, having exposed major deficiencies in the maintenance of capital rules, certain important changes are necessary which are intended to point the way forward to a system more suited to the 21st century.

In section 8.2, based on the arguments in chapter one that banks, institutional investors and other creditors do not rely on issued share capital for their protection, but on the company’s projected cash flows and on its net assets, it is suggested that, corporate

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¹ For purpose of this study, the phrase transactions affecting share capital will also be used synonymously to refer to corporate distributions to shareholders (such as share buy-back and dividend distribution), and other forms of payments and return of capital (such as financial assistance and reduction of capital). (This is because solvency is essential as a pre-condition to corporate distributions and payments).
² These so called ‘optimum approach’ or ‘fundamental safeguards’, would not only displaced the common law notion of capital maintenance mechanisms but would extensively strengthened the protection of corporate shareholders.
distributions, payments and return of capital be regulated using a cumulative dual solvency approach, reinforced by a mandated debt-to-equity ratio test. In section 8.3, to strengthen any existing creditor and shareholder protection devices discussed in the various chapters, and to address the problem of conflicts of interests and agency costs, stakeholder protection will be reinforced by the insolvent trading provisions (s 588G), contractual covenants and the oppression remedy provisions (s 232ff). Section 8.4, concludes the study by providing an argument for retaining the doctrine for the future.

8.2 Optimum Regulation: Solvency Requirement & Debt-to-Equity Ratio

The status of a company’s share capital is usually of little importance to creditors since the designated figure in the company’s accounts does not constitute any sort of reliable assurance that the amount in question will be available to creditors in the event of financial distress. The sum specified as being the share capital does not have to refer to any assets or cash which the company usually owns. Since the share capital entry in a company’s accounts suffers from important limitations, those dealing with companies not surprisingly look elsewhere for reassurances concerning creditworthiness. Arguably, a company’s capacity to pay its debts is determined in large measure by its business prospects. Banks, for example, demand a business plan and cash flow forecasts. Since share capital rules provide little useful protection to creditors, the policy implication is that the legislature should repeal legislative restrictions on corporate transactions based on preserving share capital and in their stead, have solvency requirements which are reinforced by the debt-to-equity ratio as regulatory measures.

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4 It is importantly noteworthy that this chapter does not the least intend to comprehensively analyse the technicalities of the various sections comprising either the s 588G insolvent trading provisions or, the s 232ff oppression remedy provisions. There is already an abundance of literature to that effect. Those two bodies of legislation will focus only on the beauty of those provisions strengthening the protection of creditors and shareholder.

5 A criticism often mentioned is that share capital does not refer to any assets which the corporation actually owns as of the date of the balance sheet. Rather, it refers to an abstract number that is obtained by multiplying the number of shares by the par value or issue price of each share, or in the case of no par value, to the number stated by the board of directors. Because this number is unrelated to economic facts relevant to creditors, creditors prefer to rely on the assets and future prospects of the corporation as reflected by the entire range of information shown on contemporary balance sheets and income statements. (See generally, Brian Cheffins, above n 3, 532; Cohn, “Capital Structure, Dividends and Redemption-Time for a Change of Florida’s Corporate Code” (1982) 56 Fla B J 574, 577; B. Manning and J. Hank, Jr., Legal Capital, 3rd (ed) (New-York: Foundation Press, 1990) at 85).

6 B. Manning & Hank, ibid at 7-8, 88-95.

7 To the extent that lenders focus on a company’s accounts when they make decision, they look at items other than the share capital (see, B. Cheffins, above n 3, 535).
8.2.1. The Solvency Requirements.

The concept of insolvency or, of a solvency requirement in corporate transactions for the protection of corporate stakeholders seems well nigh universal. The legal significance of insolvency is that a company is insolvent when it is unable to pay its debts. Inability to pay debts is the fundamental concept on which all insolvency law is based. There is more than one test for determining whether a company is unable to pay its debts. The insolvency, bankruptcy and related legislation prescribe a variety of tests for determining whether a company is to be deemed insolvent for the purpose of the relevant statutory provisions. These various tests fall broadly into two groups namely, the cash flow test (inability to pay debts as they fall due) and the balance sheet test (a shortfall of assets in relation to liabilities). Though there is an apparent debate about the relevant legal tests of insolvency, modern statutes rely on one or other of these tests, or a combination of both. This study uses case and statute law to suggest that a dual and cumulative solvency approach will be the most efficient way to regulating transactions affecting corporate capital. There is a remarkable dearth of English authority on the meaning and content of the two primary tests.

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8 This assumption lends support to the fact that most jurisdictions cited in this study, make use of either one or a combination of the two types of the primary solvency tests in regulating distributions, return of capital and other payments to shareholders. Such is the position in Australia (ss 95A & S 588G of the Corporations Act 2001), New Zealand Companies Act 1993, s 4; Canadian Business Corporations Act 1990, s 42; Revised Model Business Corporations Act 1990, s 6.4(a-c); California Corporations Act 1985, §500; Insolvency Act 1986 (UK), ss 122-124 & s 214.

9 ‘Insolvency’ (insolvant), is a ubiquitous term. The term has been introduced in Australian Insolvency legislation (Corporations Act 2001 (Cth), s 95A & s 495A & Bankruptcy Act 1966 (Cth), s 5(2) & (3) (as amended). Section 95A (1) states: “A person is solvent if, and only if, the person is able to pay all the person’s debts as and when they become due and payable”. Section 95A (2) provides that a person who is not solvent is insolvent. In ascertaining the solvency of a company, according to Australian law, one must look at the cash flow of the company to determine its liability to pay debts. In comparable context, it is used in the sense of inability to meet obligations as they mature: Woolverton v G.H. Taylor Co, 43 ILL App 424 (1891), or its net assets are less than its net liabilities. The New Zealand Companies Act 1993, ss 4 (1) (a-b) & s 4 (2) defines ‘solvency’ as a situation whereby a company is able to pay its debts as they become due in the normal course of business; and the realizable value (i.e., in relation to an asset, means the price that would be paid for that asset by a willing buyer to a willing seller) of the company’s assets is greater than the aggregate of the present value of its liabilities including contingent liabilities.


11 See, Insolvency Act 1986 (UK), Bankruptcy Act 1966 (Cth) (as amended).

12 Insolvency Act (ibid), s 123(1) (e) & s 123 (2). It is to be noteworthy that the statutory expression of the distinction between the two methods of insolvency is different slightly from s 80(4) of the 1862 Companies Act which embodied a single general formulation, namely that a company was to be deemed insolvent “whenever it is proved to the satisfaction of the court that the company is unable to pay its debts”.

13 Some jurisdictions opt either generally or exclusively for one test. This is the case in Australia where both the Corporations Act 2001 and the Bankruptcy Legislation Amendment Act 1996, define insolvency in cash flow terms for all purposes.

14 This approach is consistent to the Canadian Bankruptcy and Insolvency Act 1985, s 2; Insolvency Act 1986 (UK), s 123(1) (c); New Zealand Companies Act 1993, s 4(1) & (2).

8.2.1.1. Cash Flow Solvency

Under the cash flow,\(^1\) or commercial insolvency test, which is the only test applied in Australia,\(^2\) a company is insolvent when it is unable to pay its debts as they fall due.\(^3\) For this purpose, the fact that its assets exceed its liabilities is irrelevant; if it cannot pay its way in the conduct of its business the company is insolvent. There is no reason why creditors should be expected to wait while the company realizes assets some of which may not be held in readily liquidated form.\(^4\) The court, in examining whether a company is suffering cash flow insolvency, will consider whether the company is actually paying its debtors.\(^5\) This is consistent with s 588G(1A) which states when a debt is incurred for purposes of the insolvent trading provisions and, requires that before company directors make any distribution or payments to shareholders, they must consider whether the company is able to pay its debts as and when they become due and payable.\(^6\) A company which cannot meet its debts as they fall due is considered insolvent for the purpose of establishing a winding-up order or administration.

The cash flow test is relevant since many trade creditors have a very short time horizon. Because they are concerned about the business’s ability to keep its accounts current on a day to day basis, they do not care about the share capital on a firm’s balance sheet. As Manning puts it:

The general trade creditors’ real concerns are at very close range and in an immediate time frame ...

The trade creditor measures his world in days and hours; his concern with ancient business history is minimal; his regard for subtleties of balance sheet accounting is almost non-existent.

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\(^1\) Alternative names include Liquidity insolvency or Equity insolvency.

\(^2\) Some old cases interpreting solvency in this jurisdiction make reference to a balance sheet insolvency test. See, for example, Rees v Bank of New South Wales (1964) 111 CLR 210 at 218 per Barwick C.J. Corporations Act 2001 (Cth), s 589(4) confines the meaning of ‘unable to pay debts’ for purposes of offences created by ss 589-590 to a case of unsatisfied execution. See also, Insolvent Act 1986 (UK), s 123 (1) (c).

\(^3\) R. Goode, above n 10, 68.

\(^4\) Under Australian case law, proof that a creditor’s debt has not been paid, standing alone, does not establish insolvency. The section 95A test requires ascertainment of the company’s existing debts, its debts within the near future, the date each will be due for payment, the company’s present and expected cash resources and the date each item will be received. The court’s task is to decide whether the company is suffering from a temporary lack of liquidity in which case, it is insolvent (see, Bank of Australasia v Hall (1907) 4 CLR 1514; Sandell v Porter (1966) 115 CLR 666 at 670) or that the company is suffering from an endemic shortage of working capital: Hynix Concrete Pty Ltd v Carrivy (1977) 13 ALR 321 at 328. For a detailed analysis, see, A. R. Keny, "The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidation" (1995) 21 Monash U LR 305, 307.

\(^5\) This approach is further consistent with certain provisions of the Corporations Act. (Soc: s 254 (B) (1) (b) which states that a company may only reduce its share capital if the reduction does not materially prejudice the company’s ability to pay its creditors.) Similar statement is found in s 257A (a) & 257I (on share buy-back) and s 260A (1) (a) (ii) on financial assistance for the purchase of shares.
wants cash, he wants it promptly, he cares little where else the debtor's earlier held cash may have
gone, and he will act immediately in one institutional way or another if he is not paid.\textsuperscript{22}

8.2.1.1.1. Judicial Explanation

The cash flow test of insolvency was laid down in \textit{Sandell v Porter}.\textsuperscript{23} There, the High
Court (in considering the meaning of insolvency under s 95 of the \textit{Bankruptcy Act})
observed that it was important not to confuse insolvency with a temporary lack of
liquidity. Barwick CJ said:

\begin{quote}
Insolvency is expressed in s 95 as an inability to pay debts as they fall due out of the debtor's own
money. But the debtor's own moneys are not limited to his cash resources immediately available.
They extend to moneys which he can procure by realization by sale or by mortgage or pledge of
his assets within a relatively short time- relative to the nature and amount of the debts and to the
circumstances, including the nature of the business, of the debtor. The conclusion of insolvency
ought to be clear from a consideration of the debtor's financial position in its entirety and
generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity. It
is the debtor's inability, utilizing such cash resources as he has or can command through the use of
his assets, to meet his debts as they fall due which indicates insolvency. Whether that state of his
affairs has arrived is a question for the court and not one to which expert evidence may be given
in terms though no doubt experts may speak as to the likelihood of any of the debtor's assets or
capacities yielding ready cash in sufficient time to meet the debts as they fall due.\textsuperscript{24}
\end{quote}

The above reasoning has been followed and applied in subsequent recent judgments.

Thus, in \textit{Manpac Industries Pty Ltd v Ceccattini}\textsuperscript{25}, Young CJ in Eq said:

\begin{quote}
Solvency and insolvency are defined in s 95A of the \textit{Corporations Act} as meaning a company which is
unable to pay all its debts as and when they become due and payable. This, as Lindgren J pointed out
in \textit{Melbase Corp Pty Ltd v Seganhoe} (1995) 17 ACSR 187, requires a cash flow test rather than a
balance sheet test. Again, as His Honour said in that case, when one is applying the cash flow test, it is
relevant to take into consideration the relationships between creditor and debtor, any agreement and
the course of conduct. In \textit{Hamilton v HBP Steel Ltd} (1995) ACLC 1548 I indicated that that course of
conduct may mean that despite what is written on the invoices etc as to time for payment, industry
practice or dealings between the parties demonstrate that everyone accepts that debtors will often not
pay creditors within normal trading terms.
\end{quote}

\textsuperscript{22} B. Manning & H. Hank Jr, above n 5, 90.
\textsuperscript{23} (1966) 115 CLR 660.
\textsuperscript{24} Ibid at 670.
\textsuperscript{25} [2002] NSWSC 330. Also see, \textit{Emmanuel Management Pty Ltd & Ors v Foster Brewing Group Ltd & Ors} [2003]
QSC 205.
In business circumstances sometimes it is quite necessary in an industry which is experiencing recession because otherwise creditors may not be able to sell their product at all. Even though they would prefer people to stick to their 30 day terms it is better to have recalcitrant debtors than sell no product at all. What I said in Hamilton seems to have been developed into a much stronger statement by counsel in Emwest Products Pty Ltd v Olifent (1996) 22 ACSR 202 at 209-210 and in Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation (2001) 39 ACSR 305 at 315. However, if what is said in Hamilton is properly examined, it will be seen that the proposition expounded is not only quite in accordance with authority, but is also good commercial and legal common sense.26

Also, in Rees v Bank of New South Wales,27 Barwick CJ, in considering whether a trader was able to pay its debts as and when they fell due, said:

It is quite true that a trader, to remain solvent, does not need to have ready cash by him to cover his commitments as they fall due for payment and that in determining whether he can pay his debts as they become due regard must be had to his realizable assets. The extent to which their existence will prevent a conclusion of insolvency will depend on a number of surrounding circumstances, one of which must be that the nature of the assets and in the case of a trader, the nature of his business.28

8.2.1.1.2. Difficulties with the Cash Flow Test

While the statutory requirement of the cash flow test presupposes insolvency by reference to a company’s inability to pay its debts, the test raises a number of questions not fully explored in Anglo-Australian law. Goode29 summarizes the relevant questions thus:

- What is the meaning of debts?
- To what extent, if at all, may or should the court look at debts becoming payable in the future?
- Are debts to be included which though legally due, are not the subject of any current demand for payment?
- Is ability to pay debts to be determined exclusively by reference to the company’s own money or can the prospect of raising funds through borrowing or the disposal of assets be taken into account?
- Must it be shown that the company is able to pay its debts exactly on the due date or is some margin of tolerance to be allowed?

26 Ibid at 340-341.
27 (1964) 111 CLR 210
28 Ibid at 218.
29 R. Goode, above n 10, 77.
In response to some of the above questions, the court held in *Bank of Australasia v Hall* that in determining when a debt is due and payable, the court looks at the overall financial position of the company and adopts a commercial, rather than a technical view of solvency. ‘Inability to pay debts as they fall due’ indicates a continuous success of debts rather than a calculation of debts existing on any particular day. The essential question according to the court is whether the company’s financial position is such that it can continue in business and still pay its way. The court therefore has to consider whether any liquidity problem the company may have is purely temporary and can be cured in the reasonably near future. For this purpose, the court will have regard not only to debts due and payable at the date for assessment but also to claims falling due in the near future.

Absolute reliance on only the cash flow test raises serious doubts as to whether it adequately tests liquidity despite contrary views by the courts. In *Sandell v Porter*, the court focusing on the cash flow test assumed it effectively tested liquidity. Such a view is seriously flawed. Arguably, it is unclear whether a debtor who fails the cash flow test but has sufficient assets to meet debts should be treated as insolvent and thus subject to bankruptcy or liquidation. It has been suggested that many apparently solvent companies may well fail the cash flow test. Thus, in *Imperial Motors (UK) Ltd*, the debtor was insolvent under the cash flow test but solvent under the net asset test. An interesting illustration is *Salomon v Salomon*, wherein, Salomon appears to have been insolvent under a liquidity test but not under the balance sheet test.

8.2.1.2. **Balance Sheet Solvency**

There is a surprising variety of approaches with the balance sheet solvency test in those jurisdictions applying it. The common notion with this second limb of the solvency requirement is that the company’s assets are insufficient to discharge its liabilities. The

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30 (1907) 4 CLR 1514 AT 1528.
31 Refer also to, *Expo International Ltd v Chant* [1979] 2 NSWLR 820.
32 (1966) 115 CLR 666.
35 Alternatively known as the Net Asset solvency or Bankruptcy solvency test.
36 See for example, *Companies Act 1993* (NZ), s 4(1) (b) requires the realizable value of the companies assets to be greater than the aggregate of the present value of its liabilities including contingent liabilities. See also, *Canadian*
idea underlying this test is that it is not sufficient for the company to be able to meet its current obligations if its total liabilities can ultimately be met only by the realization of its assets and these are insufficient for the purpose.\textsuperscript{37}

Under this test, the Insolvency legislation (UK) adopts two different formulations, but with similar effect. Section 123(2) specifically requires account to be taken of contingent and prospective liabilities.\textsuperscript{38} This provides an applicable test of insolvency for the purposes of winding-up, administration and avoidance of transactions. Section 124(b), in defining insolvent liquidation, speaks of 'debts and other liabilities and the expenses of winding-up. The balance sheet test is important in many respects. It is used as a ground for disqualification of UK directors.\textsuperscript{39} Furthermore, it is also one of the tests prescribed for the purpose of winding up, administration or the avoidance of transactions at an undervalue, preferences and floating charges.\textsuperscript{40} This is also the sole test used by the English legislation for the purpose of identifying an insolvent liquidation under the wrongful trading provisions (an equivalent of Australia's insolvent trading provisions).\textsuperscript{41} Moreover, it is useful as a ground for a contribution order for wrongful trading.\textsuperscript{42}

In determining whether a company has gone into insolvent liquidation for the purposes of an order under s 214 of the Insolvent Act 1986, the test is that the assets are insufficient for the payment of its debts and other liabilities and the expenses of winding-up.

In Re Tweed Garages Ltd, Plowman J put it in the following way:

The particular indications of insolvency ... are all instances of commercial insolvency, that is, of the company being unable to meet current demands upon it. In such a case it is useless to say that if its assets are realized there will be ample to pay 20 shillings in the pound: this is not the test. A

\textsuperscript{37} Business Corporations Act 1990, ("BCBA") s 40; Revised Model Business Corporations Act 1989, ("RMBCA") s 6.40(1) (a). This test is alternatively known as the Net asset solvency or Bankruptcy solvency test.

\textsuperscript{38} See, R. Goode, above n 10 at 69.

\textsuperscript{39} Insolvency Act 1986 (UK), s 123(2) provides:

"A company is deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company’s assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities."

\textsuperscript{40} Disqualification Act 1986 (UK), s 6.

\textsuperscript{41} Insolvency Act 1986 (UK), s 238.

\textsuperscript{42} Insolvency Act 1986(UK), s 214.

The reason for the exclusive use by the English of the balance sheet test in the wrongful trading provisions is that there is no reason to impose liability of the delinquent directors to contribute to the assets of the company except where the assets are insufficient to meet liabilities and the expenses of winding-up. Contra this with the Australian position where the cash flow test is the sole test in the insolvent trading provisions.
company may be at the same time insolvent and wealthy. It may have wealth locked up in investments not presently realizable; but although this is so, yet if it has no assets available to meet its current liabilities it is commercially insolvent...

8.2.1.2.1. Some Problems in the use of the Balance Sheet Test

Reliance on the balance sheet test in determining a company’s insolvency is usually a reliable indicator. However, it raises its own interpretational difficulties. In marginal situations, the basis of valuation and the assessment of values upon that basis can be crucial. In an earlier discussion under the rule on consideration, it was argued that the valuation of assets was not an exact science. Different accountants may have different views on the proper approach to a particular valuation, and in relation to valuation of particular assets, valuers may place widely differing values on the same asset. It is thus perfectly possible to envisage a situation in which the application of the balance sheet test shows on one reasonable view that a company is solvent and on another, equally reasonable view that it is insolvent.

Just as problems may arise in the valuation of assets, so also there may be difficulties in the estimation of liabilities. This is particularly likely to be the case as regards unquantified existing liabilities, contingent liabilities, realizable value of assets and the expenses of liquidation. It may often be difficult to ascertain, for example, the realizable value of a company’s assets. Since a realizable value is said to be the price that would be paid for an asset by a willing buyer to a willing seller, everything must have a price so that a company’s assets must be able to be sold for something. The difficulty is that in every given market at any given time there may be no buyers for an asset at a price which could be regarded as realistic. It would be unfair to make a company reduce the valuation of an asset merely because in the peculiar market conditions prevailing the asset would

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43 [1962] Ch 406 at 410. See also Lee Kong v Pilkington (Aust) Ltd (1997) 25 ACSR 103 where Owen J said: “A comparison of a corporation’s current assets and current liabilities may provide a useful guide to the overall ability of the company to pay its debts. The comparison between current assets and liabilities, either in absolute form, or as a working capital ratio, can reveal whether a company will have sufficient funds on hand to pay the debts that will soon fall due...”

44 In chapter seven of this thesis, concerning the valuation of non-cash consideration, it was suggested that the use of an independent expert valuation was a reasonable method in valuing non-cash share issues. It was acknowledged one problem was that valuation of assets was not an exact science, meaning there can be some scope for distortion.

45 This view point is consistent to that of R. Goode, above n 10, 98.

46 See, Companies Act 1993 (NZ), s 4(1) (b).
not be saleable at a price which would be regarded as realistic in most circumstances. It has also been argued by commentators that the balance sheet solvency test is totally inappropriate in the case of a group of companies which are extended credit by a financial institution in circumstances where all the companies within the group, guarantee the obligations to the financial institution of all other group companies.\footnote{\textsuperscript{47}}

\subsection*{8.2.1.2.2. Some General Problems with Solvency}

Apart from the specific problems underpinning the two types of solvency tests just mentioned above, one general problem is germane no matter which test is applied—that relates to the problem of proving insolvency. The documentary evidence seen as most relevant to the proof of insolvency was identified as dishonored and postdated cheques, debtor’s statements of affairs, balance sheet and profits and loss statements.\footnote{\textsuperscript{48}} Expert accounting evidence is admissible to provide an opinion on whether a debtor is insolvent, but the weight of this evidence will depend on the extent to which the court accepts that the assumptions upon which the expert’s conclusion are based are supported by other evidence.\footnote{\textsuperscript{49}} The difficulties of proof have given rise to the necessity for presumptions in order to make litigation manageable.

As a ground for winding-up and bankruptcy, insolvency is presumed from a failure to comply with a demand.\footnote{\textsuperscript{50}} Although this suggests cash flow insolvency rather than net asset insolvency, it can further create more difficulties. One of the most striking was illustrated by \textit{Cornhill Insurance plc v Improvement Services},\footnote{\textsuperscript{51}} in which a clearly solvent company which refused to meet an apparently undisputed debt was unable to prevent the creditor from proceeding with a winding-up application. However, so long as insolvency

\begin{itemize}
\item See, Re Taylor’s Industrial Flooring Ltd (1990) BCC 44; Mine Executive Pty Ltd v Henderson Drilling Services Pty Ltd (in liq) (1989) 1 ACSR 118.
\item Refer generally to, Leslie \textit{v} Howships Holdings (1997) 15 ACLC 459; Quick \textit{v} Stoland Pty Ltd (1998) 29 ACSR 130. Some commentator’s assume that the balance sheet test would ease the problems of proof. (See, J. Dunn, “Insolvency: Problems of Concept and Proof” (2000) 28 \textit{A&LR} 22, 33). Balance sheets may provide influential but not conclusive evidence. Also, because valuation of assets is often problematical, balance sheet may be a flawed instrument as a measurement of insolvency.
\item Corporations Act 2001(Cth), s 459C (2) (a), \textit{Bankruptcy Act} 1966, s 40(1) (g).
\item [1986] 1 WLR 114.
\end{itemize}
remains a presumption only, it is useful since presumptions can be helpful to ease the burden of proof, particularly where the relevant information is held by the defendant.\(^{52}\) Greater difficulties arise where insolvency must be shown to have existed at some point in the past, as in the antecedent transaction provisions. An important presumption introduced by the Corporations Act 1992 is that contained in the current s 588E (3). This provides that once insolvency is proven, even through the use of other presumptions, the debtor is presumed to continue to have been insolvent up until the relation back day. This is expected to encourage parties to focus all efforts on proving insolvency at a particular time.\(^{53}\)

### 8.2.1.3. Cumulative Dual Solvency (A Preferred Option)

Judging by the different legislative approaches, the number of authorities and the discussion contained in those authorities, the question whether a company satisfies the criteria of the solvency requirements for the purposes of corporate transactions cannot be gleaned in isolation. (That is, neither test can satisfactorily determine whether a particular transaction would leave the company solvent or insolvent.). The difficulty of drawing a clear line of distinction as to which sense a company is insolvent is well illustrated in Salomon v Salomon.\(^{54}\) There Salomon’s company was solvent when it commenced business. He had discharged all the outstanding trade debts, and his own lending fell well short of the company’s total assets.

There was a substantial surplus of assets over liabilities, but the company became unable to pay its debts, and so became insolvent on a cash flow basis. What is not clear was whether it was ever insolvent on a balance sheet test.\(^{55}\)

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\(^{52}\) See Corporations Law Reform Act 1992 and the Harmer Report, which both create a rebuttable presumption of insolvency where a company fails to keep proper accounting records.

\(^{53}\) This presumption is rebuttable, sec. s 588E (a). Presumably, it could be rebutted by evidence of a corporation’s solvency at any time after the date on which insolvency had been shown. One commentator suggests that the U.S presumption of insolvency for 90 days prior to winding-up is noteworthy for adoption (see J. Dunn, above n 49, 34).

\(^{54}\) [1897] AC 22.

\(^{55}\) The Salomon case illustrates that a cumulative dual solvency test is the preferable approach since a company that relies on one or the alternative test, may be insolvent say, in a balance sheet sense but capable to protect its creditor’s or shareholders because it is adequately solvent in its cash flow sense. (The converse is true). The dual solvency tests prohibits distributions and payments out of corporate resources that would cause either the cash flow or the balance sheet insolvency.
Although there is a lack of theoretical discussion as to whether there is an ideal insolvency concept, presumably, the best tactical option would be to employ the cumulative dual solvency tests. (i.e., both the cash flow and the net asset tests must be considered as a composite requirement). Both tests determine the financial viability of a company and signal information to lenders whether to continue lending to the company. They also signal to directors whether the company is solvent or insolvent and capable of paying its debts as they become due and payable. In *Quick v Stoland Pty Ltd*, the court heard an appeal from a successful action against a director for insolvent trading. One of the members of the court, Emmett J in considering when a company was insolvent provided a useful recent guide by adopting a dualistic approach to solvency. His Honour said that in order to determine whether a company was solvent at a given time, it would be relevant to consider the following matters:

- All of the company’s debts as at that time in order to determine when those debts were due and payable;
- All of the assets of the company as at that time in order to determine the extent to which those assets were liquid or were realizable within a time frame that would allow each of the debts to be paid as and when it became payable;
- The company’s business at that time in order to determine its expected net cash flow from the business by deducting from projected future sales the cash expenses which would be necessary to generate those sales;
- Arrangements between the company and prospective lenders, such as its bankers and shareholders, in order to determine whether any shortfall in liquid and realizable assets and whether cash flow could be made up by borrowings which would be repayable at a time later than the debts.

His Honour also observed that two further, but not determinative indicators of insolvency were a company’s working capital and its net asset position. To this effect he added:

> It is often accepted as a rule of thumb, that a company will be regarded as insolvent if its current liabilities exceed its current assets. However, that cannot be more than a rule of thumb. A company might satisfy that requirement yet it may be shown, on a more careful analysis, not to be able to pay its debts as and when they become due. Equally, a company could fail that test, but still be able to demonstrate that it can pay all its debts as and when they become due and payable. Further, a deficiency of total assets to total liabilities is not conclusive as to insolvency.

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57 Ibid at 138.
A company could have a deficiency of net assets yet, because of a very strong profit making business, be in a position to pay all its debts as and when they become due and payable. That is to say, even if a net asset deficiency exists reasonable projections may indicate that the company would generate sufficient profits to be able to eliminate that deficiency before the long term debt becomes due and payable. The company would be solvent in those circumstances.\(^{58}\)

The New Zealand,\(^ {59}\) Canadian,\(^ {60}\) English\(^ {61}\) and American\(^ {62}\) rules on distribution are based on a company being solvent at the time and after a transaction take place. Those jurisdictions in general, place an obligation on the board of directors to ensure that the company will satisfy a cumulative dual solvency test (i.e., both a cash flow and balance sheet tests). Since the normal rule in a corporate insolvency is that all creditors are treated on an equal footing (pari passu) and share in insolvency assets pro rata to their insolvency entitlement, or the sums they are due,\(^ {63}\) a corporation’s cash flow and balance sheet would, for example, show with reasonable clarity what sums were available for buy-back, reduction of capital, financial assistance and dividend distribution.

One writer noted that even a simple network of assets to represent the whole residual equity would suffice to a large extent without necessarily distinguishing whether the sums which required to maintain share capital, capital assets and profits.\(^ {64}\) The protection of creditors as previously illustrated does not necessarily depend upon limiting withdrawals to share capital or distributable profits. If an adequate relationship is maintained between cash flows, total assets and total debts, that is more protective to creditors.\(^ {65}\)

Though the dual solvency test as it appears in some modern statutes has some merits of simplicity, there are also deficiencies. First, the dual solvency test provides no consistent

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\(^{58}\) Ibid at 139.

\(^{59}\) Company’s Act 1993, s 4.

\(^{60}\) Canadian Business Corporations Act 1990, s 42.

\(^{61}\) Insolvency Act 1986, ss 123 (1) (c) & (2).

\(^{62}\) Revised Model Business Corporations Act 1985, s 6.40(c).


\(^{64}\) A. C. Littleton, "A substitute for Stated Capital" (1938) 17 HLR 75, 77.

\(^{65}\) The cumulative dual solvency requirement restraint distributions and payments to shareholders that would cause either cash flow insolvency (inability to pay debts as they become due), or net assets insolvency (total liabilities exceeding total assets). Refer also to, R. Ashton, “Cash Flow Accounting: A Review and Critique” [1976] J Bus Fin & Acc 63, 81.
rule for determining the amount of allowable distribution. Neither does a dual insolvency test determine how to calculate balance sheet insolvency.\textsuperscript{66} Second, the dual insolvency test serves merely to ascertain, rather than predict, bankruptcy and it is therefore useful only after the fact as a tool for litigation not planning.\textsuperscript{67} This dual solvency approach, though supported by authorities and reasonably persuasive does not lend support to the fact that total reliance on the solvency requirements alone would regulate corporate transactions and adequately protect corporate stakeholders. Alternatives measures such as the debt-to-equity ratio and the insolvent trading provisions would need to be taken into consideration to reinforce the existing solvency requirements.

\subsection*{8.2.2. The Debt-Equity-Ratio}

Due to the considerable scope for variation in the way the solvency requirements are implemented, the solvency test restraints on distribution can be reinforced and strengthened by a supplementary test which restricts shareholder asset transfer on the basis of gearing (i.e., ratio-of-debt-to-equity).\textsuperscript{68} The strength of this conjecture may be tested through examining actual loan contracting practices. The available empirical evidence suggests that loan covenants used in the U.S. and U.K. lending agreements typically take the form of gearing and other financial ratios.\textsuperscript{69} The capital maintenance doctrine which requires that dividends be paid only out of distributable profits is designed to protect creditors. It was argued in previous chapters that creditor protection does not rest upon any issued capital.\textsuperscript{70} It was suggested that creditors can be better protected by the solvency of the company and, upon the relative proportion which debt and stock bear

\textsuperscript{66} The California Code, § 500 which uses the debt-to-equity ratios (financial ratios), provide some guidance by requiring financial statements to comply with generally accepted accounting principles.

\textsuperscript{67} Cf § 500(b)(1) of the California Code which in contrast, attempts to predict bankruptcy by introducing a predictive factor of one quarter into the total assets ratio. It requires the same predictive factor in the current ratio when circumstances suggest a higher probability of bankruptcy. Section 500 (b) is therefore assumed to be the only existing statute to use a combination of financial ratios (debt-to-equity ratios) which contain predictive factors governing distributions to shareholders (see, Y. Ben-Dror, “An Empirical Study of Distribution Rules under California Corporation Code § 500: Are Creditors Adequately Protected?” (1983) 16 U Calif Davis L R 379, 381; R. Jennings and Buxbaum, Corporations, 5th ed (1980) at 922.

\textsuperscript{68} For purposes of this study, the different terms, ‘financial ratio’, ‘gearing’, ‘debt-to-equity ratio’ ‘bankruptcy prediction model’ will be used interchangeable to mean one and the same thing.


\textsuperscript{70} For criticisms of the capital maintenance doctrine and weaknesses of the payment of dividends out of profits test, see above Chapter I (criticisms of maintenance of capital) and Chapter 5 (weaknesses on the rule on dividends).
to assets. Studies suggest that a company with a high ratio of assets to debts affords high protection to creditors because of the stringent constraints which companies have to satisfy under this test.

The financial ratio or debt-equity-ratio test further draws support from the *California Corporations Code 1990*, §500. Studies, both theoretical and empirical, suggest that the use of the financial ratios under this statute to regulate corporate distributions has been an efficient means of protecting creditors of both small and large corporations. Section 500(b) requires that a corporation may only make distributions to shareholders if it can meet two financial ratios tests. These are the “total ratio test”-relating to total assets to total liabilities (i.e., it is a leverage ratio which measures the relative proportion of total assets that have been funded by creditors and equity holders) and, the “current ratio test”- (i.e., the corporation must have current assets which at least equal current liabilities).

The essence is that management must decide whether, as a result of any distribution the corporation is likely to be able to meet its liabilities as they mature. Section 500 generally prevents any distribution if the assets of the company are less than one and one-fourth times its debts. This part of the study will demonstrate that both private and public companies adopt both a total and current ratio tests

### 8.2.2.1. Total Ratio Test.

This is a leverage ratio which measures the relative proportion of total assets that has been funded by creditors and equity-holders. It is a simple way of depicting the extent of debt financing of the corporation, and may suggest potential borrowing power. The total ratio test which can also be generally expressed as a debt-to-equity-ratio, states under s 500(b)(1), that before a corporation could make any distributions or payments to shareholders, the assets of the company must at least be equal to or, exceed one and one

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71 This view bears some limited resemblance to that of, A.C. Littleton, above n 64.
72 See generally, D. Citron, above n 69, Day & Taylor, above n 69.
74 See generally, Ben-Dror, (Ibid); T. C. Ackerman & J.K. Sterret, “California’s New Approach to Dividends & Reacquisition of Shares” (1976) 23 U CLA LR 1052, 1053.
Chapter 8

8.2. Debt-Equity Ratio

quarter times its total liabilities. Graphically illustrated, by definition, Liabilities (L) plus Equity (E) equal to Assets (A); that is \( L + E = A \). If assets equal one and one quarter times liabilities, then \( L + E = 1\frac{1}{4} \times L \). Subtracting \( L \) from each side of the equation, \( E = 1\frac{1}{4} \times L \), from which it follows that \( L = 4 \times E \). Thus, s 500(1) (b) can be read to require that no distribution would be made by a corporation unless the debt-to-equity ratio following the distribution is four-to-one or less.

8.2.2.2. Current Ratio Test.

According to s 500(b) (2), this test is one measure of the corporations’ ability to meet maturing short term debts. It is assumed by the legislation that the higher the current ratio, the greater the margin of safety for meeting current debts in the event of a sudden reduction of cash flows or in the value of current assets. The current ratio indicates whether a company has sufficient assets on hand to satisfy debt obligations that will fall due in the near future. The relevant figure is calculated by dividing current assets (e.g., cash, inventory on hand, debts to be paid to the company within a year) by current liabilities (usually debts owed by the company which are due within one year). The use of a combination of financial ratios to evaluate corporate solvency and stability is commonly referred to as a financial distress or bankruptcy prediction model.

8.2.2.3. The Importance of the Financial Ratio Test.

In the U.S., empirical studies document that Government regulatory bodies successfully use bankruptcy prediction models and financial ratios to monitor the solvency and stability of corporations such as insurance companies and banks. Similar studies suggest that auditors and lenders use such ratios as a basis for determining whether a business will continue as a going concern, and to evaluate the creditworthiness of corporate

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75 Since under accounting terminology liabilities plus equity equals assets, a corporation’s borrowings correspondingly cannot be more than four times shareholders’ funds (i.e., the debt-to-equity ratio is not to exceed four-to-one) (Y. Ben-Dror, above n 73, 383).
76 It is suggested that under this ratio, courts could look to the company’s day-by-day real time position to establish a company’s ratio. For a detailed understanding of this ratio and formula, see generally, H. Marsh, California Corporate Law and Practice (1982) at 13.9; Y. Ben-Dror, (Ibid), 384.
borrowers.\textsuperscript{79} The \textit{California Code} presents a modern approach to the regulation of distribution and other corporate transactions to shareholders. Section 500 (b)'s use of a bankruptcy prediction model to detect financial distress and prohibit distributions before the onset of insolvency is a practical, economic method of governing distribution and protecting creditors.\textsuperscript{80}

The debt-equity-ratio is also important as a requirement for continued corporate status. Hence, limited liability status might be withdrawn once the required ratios were not achieved. Since a shareholder may fund a corporation by both debt and equity, in either circumstance he/she enjoys limited liability.\textsuperscript{81} The shareholder who provides debt may place themselves in the position of a secured creditor by, for example, taking a fixed and floating charge over all assets of the company. The tort or trade creditor is not usually privy to such an arrangement. If the company becomes insolvent, the secured shareholders will rank in priority before the unsecured tort and trade creditors. Section 500 can then be used, empowering creditors to require a company to comply with a specific financial ratio to the effect that, a statutory proportion of assets one and one-quarter times the debts would have placed a restriction upon asset withdrawals.\textsuperscript{82}

Alternatively, when a company is insolvent, one of the ways of restoring the company's equity cushion is for the necessary capital to come from the company’s creditors by means of a conversion of their debt into equity. By so doing, the insolvent Company's

\textsuperscript{79} G. Foster & Altman, "Corporate Bankruptcy Prediction and its Implications for Commercial Loan Evaluation" (1970) 53 J Comm Bank Lending 8-22.
\textsuperscript{80} See, Ben-Dror, (1983) 16 U Calif Davis LR 413; M. A. Eisenberg, \textit{Corporation and Business Association Statutes, Rules, Material and Forms}, Westbury, N.Y.: Foundation Press, 1995. It is noteworthy that the California approach has been criticized for only attempting to mimic the market to a limited extent. The legislation does not, for instance, provide creditors with the distribution restrictions most likely to appear in U S bond covenants (indentures), which are clauses limiting distributions to the sum of the net earnings the corporation has accumulated since the time of borrowing (R. O. Kumbert, "State Statutory Restrictions on Financial Distributions by Corporations to Shareholders-Part II" (1984) 59 Wash LR 185, 235.
\textsuperscript{82} But there can be a possible conflict between creditors and shareholders when in insolvency; the company had access to the issuance of new debt. The new loans have the potential of increasing the company's debt-to-equity ratio. By so doing, it dilutes the claim of incumbent debt-holders against the company's cash-flow. The bankruptcy prediction model can then be used as a safeguard in that it might prevent the company from entering into further debts or restricting the company from the onset of making any distribution that may impede the company's financial resources. (See, J. Keistersman, "Counter-trends in Financial Provisions for the Protection of Corporate Creditors: The 'MBCA' & the 'EEC' Corporate Directives" (1986) 14 DENV J Int’l Law & Policy 275, 289. G. Holmes & A. Sugden, \textit{Interpreting Company Reports & Accounts}, 5\textsuperscript{th} ed (Cambridge: Woodhead-Faulkner, 1994) at 26-7.
stock is retired, the portion of the debt that exceeds the corporations' going concern value is discharged and the creditors can issued new stock and debt in the reorganized corporation. The discharge of some of the debt and the conversion of another part into stock produces the equity cushion needed to cure the insolvency.\textsuperscript{83} Creditors generally assume that clauses requiring companies to operate in accordance with designated financial ratios provide much the same level of protection as a covenant dealing directly with distributions, and analogous transactions.\textsuperscript{84}

\section*{8.3. Essential Protection of Creditors and Shareholders}

\subsection*{8.3.1. Insolvent Trading Provisions}

\subsection*{8.3.1.1. An Overview}

The insolvent trading provisions\textsuperscript{85} which reinforce the directors' duty provisions and strengthen the solvency requirements, are in general terms, a response to failure by the traditional capital maintenance rules to provide a direct recourse to creditors against those running the affairs of the company.\textsuperscript{86} The rationale of the insolvent trading provision is to place greater responsibility on people who are directors or managers of a company at the


\textsuperscript{86} A key doctrinal foundation for this proposition is that a company is entirely distinct from those who run it. This meant that those in charge of company affairs were not under any duty to use their personal wealth to discharge the company's debts. (See, for example, Salomon v Salomon [1897] AC 22 (HL); Nordic Oil Services Ltd v Bernard [1993] SLT 1164(HL)). A director knowing his company was in serious financial trouble, was able to authorize continued trading and escape liability. (Refer, also to, Great Britain, Insolvency Law & Practice: Report of the Review Committee ("Cork Committee") (1982) Crand 8558 at 399. Admittedly, some situations did exist where a director could be held liable to the company's creditors. One was when the court lifted the corporate veil and ruled that directors were personally liable for corporate debts. Another example was when a director gave personal guarantee for business debts and the company failed. (On the law governing these situations, see C. Evans}
time that unreasonable debts are incurred. The provisions are designed to protect unsecured creditors against an abuse of the corporate form on the part of directors, by allocating the risk and cost of corporate insolvency to directors rather than creditors.88

The purpose of the insolvent trading provisions (ss 588G-M), was to impose a duty on the company's directors not to cause the company to incur debts while it is insolvent as well as to impose civil and criminal liability on those directors who contravene the provisions. This was seen as one of a series of efficient and appropriate response to the need for creditor protection, mostly, due to the concept of limited liability. Accordingly, when a company becomes insolvent, the directors are expected to ensure that the company will either trade on a cash basis, or be placed into liquidation or one of the formal alternatives to liquidation. Insolvency is the critical issue triggering the insolvent trading provisions and the protection becomes necessary only when the company is insolvent. The importance of insolvency to the insolvent trading provisions requires the employment of an appropriate insolvency concept. Given that s 588G imposes liability on directors who made distributions or payments to shareholders who suspect the company to be insolvent after such distributions and would be unable to pay its debts as they

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87 Explanatory Memorandum to the Companies Bill 1981 (Cth) para 1219.
88 See, Australian Law Reform Commission, ("ALRC") Report No 4: General Insolvency Inquiry ("Harmer Committee Report") (1992) para 272 where it was said: "Where the actions of a company's directors contribute significantly to its insolvency, creditors who face the prospect of receiving no payment or part payments of their debts on insolvency have a legitimate grievance, particularly when the directors have taken risks relying on credit given by others. This has been recognized by legislature, which has enacted provisions in an attempt to make directors liable for debts of the company where the business of the company has been conducted fraudulently or without due regard to the ability of the company to pay its debts".
89 See, s 588G (1) (a) which makes directors liable where there are reasonable grounds for suspecting that the company is insolvent. Section 1317F (1) relates to the civil penalty order. Under s 1317 M-P, a director could be guilty of a criminal offence if the director knowingly allowed the company to trade whilst insolvent for a dishonest purpose. Sections 588J-U contains the mechanical provisions supporting the duty against insolvent trading. Section 588J provides that the court may make an order for the payment to a company of compensation where there has been an application for a civil penalty order made against a director for breach of the duty against insolvent trading.
90 The reasoning is that consensual or secured creditors are in theory and practice at least, able to decide whether or not to lend, and if so how much and on what terms. They have various ways to protect themselves effectively. On the other hand, non-consensual claimants (such as unsecured creditor, tort victims are not). Because the unsecured creditors are unable to adjust the terms on which credit is extended, controlling shareholders may be able to profit at their expense by, for example reducing the assets of the corporation through improvident trading or other unauthorized distributions. For a complete legislative history of the insolvent trading provisions, see the Harmer Committee Report, above n 88 paras 277-9.
become due, this would imply that the ‘abuse’ at which the provisions are aimed occurs only where the company has insufficient funds to meet its debts (liabilities). It may seem to follow that the net asset test is appropriate in place of the cash flow test. 91 Section 588G requires an order for breach only where the company is being wound-up and can only be in respect of debts that are either wholly or partly unsecured. 92

8.3.1.2. Insolvent Trading Provisions, maintenance of capital & Creditor Protection

For the purposes of the capital maintenance doctrine, directors contravene s 588G if a company engages in transactions affecting corporate capital when there are reasonable grounds to suspect that it is insolvent. According to s 588G (1A), a company which buys-back its shares under s 257 is deemed to have incurred a debt 93 for purposes of s 588G (1A) at the time a buy-back agreement is entered into. 94 Generally also, both s 588G (1A) and s 588G will apply when a company reduces its capital under s 256. Directors are liable for breach of s 588G if, at the time when the reduction takes effect, the company was unable to pay all of its debts as and when they become due and payable or, became unable to do so by the reduction of capital. This is so because, s 588G (1A) states that if a company reduces its share capital (except where it cancels shares for no consideration) the company is taken to incur a debt when the reduction takes effect. Hence, the insolvent trading provisions will apply if the company is insolvent at the time when the reduction of capital takes effect by virtue of the reduction of capital or other debts incurred at that time.

91 This appears to be the view of The English position in relation to wrongful trading. It is also the view of Buckley J in Re White v Osmund Parkstone Ltd [Unreported 1960], quoted in Jones, “Insolvency and the Balance Sheet” (1993) 9 Insolvency Law & Practice 133, 135. But cf, R v Grantham [1984] 2 All ER 166. The Australian Law Reform Commission (The Harmer Report) had suggested that companies should be presumed to be insolvent when their liabilities exceeded their assets (“ALRC, above n 93, para 296). This recommendation was not adopted by the legislation, although creditors do benefit from a rebuttable presumption of insolvency in the circumstances set out in s 588E (for example, where the company has failed to keep adequate accounting records).

92 Section 588M (1) (c). An exception is where a civil penalty order has been made against the director or where the director is convicted of an offence under s 1317 in which case an order may be regardless of whether winding-up proceedings have been initiated.


94 If a company is insolvent when a buy-back agreement is entered into, or becomes insolvent as a consequence of entering into that agreement, a director of the company will contravene s 588G if, when the agreement was entered into, there were reasonable grounds for suspecting that the company was, or would become, insolvent, and either the director was aware that there were reasonable grounds for so suspecting, or a reasonable person in a like position in a company in the company’s circumstances would be so aware (s 588G(1-2)).
Furthermore, for purposes of the contravention of the financial assistance provisions, both ss 588G & 260A will be breached, where a company financially assists a person to acquire shares or units of shares in itself or a holding company. The company is taken to have incurred a debt under s 588G (1A) when the agreement to provide the assistance is entered into or, if there is no agreement, when the assistance is provided. This is so whether the financial assistance is approved by shareholders or is not prohibited because of an exemption or satisfaction of the material prejudice test. The consequence is that directors contravene s 588G (1) if the company was insolvent at the time of the agreement of the assistance or becomes insolvent by virtue of that conduct, or by incurring other debts at that time and at that time, there are reasonable grounds for suspecting that the company is insolvent or would be so insolvent.

Directors contravene the s 588G duty and breach the s 254T provision on dividend distribution if they fail to prevent a company incurring a debt when they suspect, or should suspect the company to be insolvent as a consequence of incurring the debt. Under s 588G (1A), a company incurs a debt in breach of s 254T when it pays a dividend pursuant to its constitution other than a dividend which had been previously declared. A debt arises immediately for the purpose of a company with a constitution, when the dividend is declared. A liquidator or creditor has standing under s 1324 to obtain an injunction to restrain the proposed payment. Section 588G (1A) deems the company to have incurred a debt when the dividend was paid or, if the company has no constitution that provides for declaration of dividends, when it was declared.

By implication, a company breaches s 588G and the various provisions of the maintenance of capital doctrine by incurring a debt if the directors fail to take reasonable steps to prevent a company from going insolvent and from preventing the company from making any distributions and payments to shareholders which may have a detrimental effect to impact on a company’s solvency. In Metropolitan Fire System Pty Ltd v Miller,95 the court decided that whether there were such reasonable grounds for so suspecting insolvency would have to be determined on objective criteria, taking into

account the different standards expected of executive and non-executive directors. Under s 1317G, the court may order that a director who breaches s 588G(1) to pay a pecuniary penalty of $200,000 if a declaration of contravention has been made under s 1317E and the contravention materially prejudices the corporation’s ability to pay its creditors. A court may further order a director who breaches s 588G(1) to be prohibited from managing a company under s 206C. The civil liability is similar to the Company Director’s Disqualification Act 1986 (UK), s 6. Conviction of a director of a criminal offence is punishable by a fine of $200,000 or imprisonment for 5 years or both.

8.3.1.3. The Beauty of the Insolvent Trading Provisions in Protecting Creditors.

8.3.1.3.1. Swelling of Corporate Resources.

The insolvent trading law of Australia, empowers a liquidator\(^6\) or ASIC\(^7\) to pursue various personal remedies against directors and others which, if successful, result in a court order for the payment of compensation that go to swell the coffers of the insolvent estate for the benefit of the debts of unsecured creditors, and also future creditors.\(^8\) This contribution to assets of the insolvent company by directors under the civil liability provisions\(^9\) is intended to be primarily compensatory.\(^10\) Section 588J(1) enables the court, on an application for a civil penalty order, to make an order that the director pay to his/her company, monetary compensation equal to the amount of loss or damage suffered by the unsecured creditors due to the company’s insolvency.\(^11\) Section 588K provides a similar scheme for compensation orders where a court finds a director guilty of a criminal offence due to a contravention of s 588G when the elements of criminality are present. Compensation received from directors goes to repair an insolvent company’s capital structure by restoring its equity cushion. Actions to swell the assets of an insolvent

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\(^6\) Section 588M(2) primarily provides the liquidator with an avenue to directly proceed against a director in breach of their duty against insolvent trading, and to recover from them, as a debt due to the company, an amount equal to the amount of the loss or damage.

\(^7\) Section 1317G-J essentially authorizes ASIC to make civil applications against directors on behalf of creditors and the company.

\(^8\) *Shepherd v ANZ Banking Corp Ltd* (1997)41 NSWLR 431. It is possible for a civil penalty order to be made against a director on behalf of the company and creditors on application of ASIC (see, s 1317EB). The court’s order of a civil penalty order of a sum not more than $200,000 contributes significantly to creditors’ claims.

\(^9\) See, ss 1317(4)-(H) which relates to the civil penalty order. Where this order is imposed, directors are made liable to compensate creditors or to contribute to the general fund for creditors. Under s 588 M (1)(c), director’s liability to pay compensation only arises if that debt is wholly or partly unsecured.


\(^11\) The quantum payable is limited to the loss or damage suffered by the creditors in relation to the debt because of the company’s insolvency: *Shepherd v ANZ Banking Corp Ltd* (1997)41 NSWLR 431.
company available for distribution have the advantage of preserving the collective regime of insolvency. Such an efficient bankruptcy law is one which enhances creditors' collective benefits.\(^\text{102}\)

### 8.3.1.3.2. Protection of Creditors and Equality in Treatment

The rationale of creditor protection underlies the insolvent trading provisions. The justification that underpins this rationale is that the company should not be allowed to externalize the cost of its debts by making creditors shoulder uncompensated risk.\(^\text{103}\)

Sections 588R-U inclusive provide the circumstances where a creditor may sue a director under s 588M for allowing a company to trade whilst insolvent. Section 1324 provides as a remedy to creditors to obtain an injunction to prevent directors from engaging in insolvent trading.\(^\text{104}\) This provision requires the company to cease incurring further debts so that the assets of the company may be preserved for the protection of both current and future creditors.

The first main theme which arises from case law on insolvent trading is the protection of unsecured creditors\(^\text{105}\) and preventing the abuse of the corporate veil.\(^\text{106}\) The vesting of

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\(^{102}\) See, Jackson, *The Logic and Limits of Bankruptcy Law* (1986) 7-9. Cf. Carlson, "Philosophy in Bankruptcy" (1987) 85 Mich LR 1341. Since the insolvent trading provisions restrict the company from externalizing the cost of its debts by making creditors shoulder uncompensated risk, it therefore has the capacity of protecting existing, continuing and future creditors. The case law goes some extent to support this. See, *Winkworth v Edward Baron Development Co Ltd* [1987] 1 All ER 114; *Hilton International Ltd v Hilton* [1989] 1 NZLR 442; *Jeffreys v NCS Conn* (1989) 15 ACLR 217. This argument has been extensively documented, see, W. J. Keoek & J. Ramsay, “The Importance of Distinguishing between Different Categories of Creditors for the Purposes of Company Law” (1994) 12 C & SLJ 105. Arguably, if the rationale of any default rules is to restrict the company’s prosperity to unilaterally increase the risk of creditors, the group of creditors most worthy of protection might be existing and continuing creditors. This is because after a debt has been incurred, the company may unilaterally increase the risk of its default at the expense of its existing and continuing creditors. On the other hand, future creditors give credit on the basis of what they perceive to be the level of risk at the time credit is given. While the compensatory remedy is advantageous to creditors, but because the amount of the compensation can be so open minded, there is the potential to cause great deal of uncertainty. Since they are not easily quantifiable, they could lead to intense litigation which may delay the creditor being paid his/her debts on time or at all.


\(^{104}\) Refer, to *Metropolitan Fire Systems Pty Ltd v Milla* (1997) 23 ACSR 699. Where proceedings are taken by a creditor under s 588R, any liability is owed to the creditor directly. In calculating the compensation payable by the defaulting director, regard is had to the loss or damage suffered by the creditor in relation to the debt because of the company’s insolvency. So far, the cases have interpreted this to mean the actual amount owed by the company to the creditor. (See, for example, *Shepherd v ANZ Banking Corp Ltd* (1977) 41 NSWLR 431.

\(^{105}\) Unsecured creditors remain the main beneficiaries of s 588G as evidenced from the remedial provisions of Division 4 of Pt 5.7B, which allows a court to order a director in breach of s 588G to pay compensation to the company for the benefit of unsecured creditors in an amount equal to the amount of the loss or damaged suffered by such a creditor (s). (See, for example, *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 10 ACLR 395 at 404, where it was held that the amounts recovered are available for distribution only among unsecured creditors because secured creditors have access to their security for money owed to them). The Harmer Committee Report justifies this
standing solely in the liquidator or ASIC with the effect that individual creditors would be completely precluded from recovering losses from company directors except by leave of court has merits generally for creditors and the company. It does not only lead to an increase in the aggregate pool of assets but also in a reduction in the strategic costs of litigation.

The restriction of standing to the liquidator and away from individual creditors also has support on the basis that as liquidators have complete access to the company’s financial books and the power to gain information from the company’s officers and employees, they are in a better position to establish a case but also, to enable all creditors to receive a pari passu contribution from the compensatory recovery, and to prevent those individual creditors with a strong financial capability to take proceedings against directors and reap the compensation to their self-aggrandizement.107 There would certainly be administrative efficiencies in collective action.108

assertion by noting that unsecured creditors are those who suffer greatest loss as a consequence of a company’s insolvent trading. (See, Explanatory Memorandum to the “CLR” Act 1992 (1995) paras 1096, 1132. See also, Corporations Act 2001 (Cth), ss 588J-588M which prescribes provisions for the application of civil penalty order, recovery of compensation for loss resulting from insolvent trading.

106 See, generally, Commonwealth Bank of Australia v Friedrich (1991) 9 ACLC 946 at 1014; ASIC v Sneigrove (1992) 10 ACLC 1542 at 1545; Explanatory Memorandum to the Corporation Law Reform Bill 1992, para 1096. Support for the view that the proceeds contributed to a company's assets are being distributed to unsecured creditors can be found in the English case of Re Oasis Merchandising Services Ltd [1995] BCC 911. However, unlike Australia, there is no provision in the UK expressly prohibiting the proceeds recovered by a liquidator from being distributed to secured creditors in priority to unsecured creditors. (See, Re Produce Marketing Consortium Ltd (1989) 5 BCC 569). Contra Re Bacon (No 2) [1990]BCLC 607, where the court held that proceeds for wrongful trading should be for the benefit of unsecured creditors. (See, also, the criticisms by F. Oditah, “Wrongful Trading” [1990] LACLQ 205, 215-220.

107 These arguments are consistent to those of, A. Herzberg, “Insolvent Trading–Civil Liability of Company Officers under Insolvent Trading Provisions” (1991) 9 CLSLJ 285, 289; J. Trethowan, “Directors’ Personal Liability to Creditors for Company Debts” (1992)20 ABLR 41, 70. A. Herzberg however argues that the parity principle may be misleading because trade creditors are advantaged at the expense of other types of creditors such as 'finance creditors. This criticism may only be sound in the sense that creditors are not often homogenous. But it would be to miss the point in assuming that trade creditors benefit at the expense of finance creditors, like banks who are generally regarded as secured creditors. Though the insolvent trading provisions may primarily focus in protecting the unsecured creditors, the secured creditors do not need to depend on s 588G for protection since they have other sophisticated means to protect themselves. (These include, loan covenants, retention of title or 'rompulafa clauses', insurance). All these means are not available to unsecured trade creditors since they lack the means to contract.

Also, because ASIC or a liquidator may initiate proceedings against holding companies, (an action not available to individual creditors), the protection afforded them by s 588G is extended to holding companies by the subsidiary’s liquidator recovering from the holding company an amount which would not have been available to any creditor action. Refer, generally, to, F. Oditah, “Assets and the Treatment of Claims of Insolvency” (1992) 108 LJR 459, 463; T. H. Jackson, “Bankruptcy, Non-Bankruptcy Entitlements and Creditors Bargain” (1982) 11 YLJ 857, 860.
8.3.1.3.3. Deterrent Effect

The section 588G provisions, to the extent that they are part of increased obligations imposed on directors, contribute in preventing a company from pursuing transactions which deplete the company’s financial resources. The civil penalty fine of $200,000, disqualification as a director or, a criminal liability of both fine and imprisonment, have a strong deterrent effect in putting controlling shareholders and managers on the alert from letting a limited company go insolvent.\(^\text{109}\) Logically, one of the implications of the s 588G duty should motivate executives to monitor corporate affairs more closely and should deter them from continuing to trade and initiate risky business ventures where things are unlikely to turn around.\(^\text{110}\) This will also be to encourage board of companies experiencing financial difficulties to more quickly resolve to appoint an administrator rather than attempt to trade through such difficulties.\(^\text{111}\)


8.3.1.4.1. Terminological Difficulties

The efficacy of the insolvent trading provisions in protecting creditors and addressing problems arising in transactions affecting share capital cannot be disputed. However, certain practical difficulties and questions may compromise the effectiveness of mechanism. The first question raised relates to the issue as to what the director should do to perform their duties to prevent insolvent trading and avoid the consequences prescribed by law.

The content of a directors’ duties is not always clear, particularly in the context of preventing insolvent trading. The same difficulty was recognized by Justice Mahoney, speaking extra-judicially:

\(^{109}\) This justification of the insolvent trading provisions was resoundingly rejected by some commentators who argue that, the s 588G provision would contribute to deterring qualified and desirable people from being directors. The argument further suggests that the s 588G duty provision generate mistrust between directors and cause them to focus on defensive practices and on their own potential liabilities rather than on a more legitimate concern. (For example, see, Australian Law Reform Commission, General Insolvency Inquiry, Discussion Paper No 30, (August, 1987); B. Pheasant, “BCA Opt for Tougher Prosecution” [1992] Aust Fin Review 3; R. Baxt, “Reforming the Law on Directors’ Duties” (1992) 10 C&SLJ 205).

\(^{110}\) On the importance of compensation and reputation attributes of a director’s duty to use care and skill, see, J. C. Lee, “Limiting Corporate Directors’ Liability: Delaware’s Section 102(b) (7) and the Erosion of Directors’ Duty of Care” (1987) 136 U Pa LR 239, 261.

Directors' duties have conventionally been stated essentially in terms of: what directors should not do ... But such a statement is of little use to a director, particular a non-executive director. It does not tell him (or her): what are the things to be achieved by him (or her) as a director, and what are the means available to him (or her) to enable him (her) to achieve them. A director needs to know these things if he (her) is to judge what he (her) is to do in a particular situation ...  

Arguably, the above question cannot be a serious problem because the introduction of s 588G has gone a long way in imposing a positive duty on a company director to prevent insolvent trading. Ormiston J, in *Re Morley* has provided a very useful guideline for directors to follow to prevent insolvency.  

There, His Honour asserted that:

Directors must apply their minds to the overall position of the company. Inquiries must be made on a regular basis especially when confronted with insufficient financial information. Directors are expected to take a diligent and intelligent interest in the information available or which he (she) might demand from executives or other employees and agents of the company. Reasonableness is related to the extent of the inquiries that the director has made and should have made about the company's solvency. A director should ask for and receive figures, albeit of a basic kind, on a more or less regular basis because it may be too late once creditors began to take aggressive attitude ...

Other technical difficulties include an explication the terms, "suspect" and 'expect' insolvency. There has been debate in the House of Representatives and by some commentators as to the adequacy of threshold in the use of the term 'suspect' and 'expect' in determining insolvency. The precise scope of either term has been criticized for being unclear and too onerous especially when viewed in conjunction with other extensions to the application of the defaulting officer's provisions. There is also a concern that the retention of the phrase, 'incur a debt' under s 588G (1) (a) produces

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112 Address by Mr. Justice Mahoney, delivered after formalities of the Annual General Meeting of the Commercial Law Association in Sydney, (21 May 1996). See also the criticisms advanced by Lawrence, "Are Directors Running Account in Breach of their Duties: (1997) 8 AClL 200, 216-217.

113 (1990) 2 ACSR 405. Also under s 588H (5-6), the law provides that a director will be exonerated from liability if he (she) can show that all reasonable steps were taken to prevent the company incurring a debt Section 588G(H)(6) contemplates reasonable steps to include, appointing an administrator when the board considers is insolvent or likely to be insolvent (see, *Byron v Southern Star Group Pty Ltd* (1997) 15 ACLC 191).

114 (1990) 2 ACSR 405 at 406.


116 3M Australia Pty Ltd v Kemish (1986) 4 ACLC 185. Arguably, these words "suspect and expect) have received much judicial analysis for us to continue to remain a problem in determining insolvency. The meaning of suspicion of insolvency was considered in *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266, 303 where Kitch J said: "A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust amounting to a slight opinion, but without sufficient evidence ..." see also *Group Four Industries Pty Ltd v Brosnan* (1991) 13 ACLC 1,381; *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115.
anomalous consequences. Section 588G sets out three requirements before a creditor’s or liquidator’s cause of action is complete. The first is the requisite proof that the company incurred the debt whilst insolvent. The question often arises as to the point in time at which the relevant debt may be said to have been incurred. The identification of that time is critical, as it determines the point in time at which assessment was to be made as to the company’s ability to pay its debts.\textsuperscript{117} It is also assumed that the difficulty of reasonably determining when a debt has been incurred, may save directors from potential liability for amounts due by their insolvent company to creditors, and achieves the result that trade creditors are advantaged at the expense of other types of creditors particularly finance creditors.

Section 588G requires the company to be insolvent at the time the debt is incurred or to become insolvent as a result of incurring the debt. However, other than insolvency being merely a factor that increases the probability of uncompensated risk, a company can be insolvent yet economically viable. Making insolvency a prerequisite to the imposition of obligation on directors may unduly constrain the directors’ decision making.\textsuperscript{118} However, judicial explication of the terminological ‘difficulties’ does not suggest that they are serious problems without a solution.

\textsuperscript{117} Judicial explanations of the phrase ‘incur a debt’ have remained inconsistent. Company directors have had difficulties in comprehending the meaning of the terms, as they are not words of precise and flexible denotation. Some cases hold that the time at which the contractual obligation was undertaken was the relevant time by which a company is said to have incurred a debt. (See, \textit{Russel Hulpern Nominees Pty Ltd v Martin} (1986) 4 ACLC 393). \textit{Cf. Hussein v Good} (1990) 8 ACLC 390. There, a company purchased a quantity of goods from a creditor with payment to be made on delivery of the goods. Delivery was duly made but there was only part payment. Subsequently, the company was liquidated and the creditor received only 3% of the outstanding debt. Southwell J held that the date of delivery of the goods was the relevant date rather than the earlier date upon which the contract was entered into. Hodgson J in elucidating on the meaning “incur a debt”, said in \textit{Standard Chartered Bank of Australia v Antico} (1995) 13 ACLC 1, 381 at 1, 429: “A company incurs a debt, when by its choice, it does or omits something which as a matter of substance and commercial reality, renders it liable for a debt for which it otherwise would not have been liable”. Though his Honour acknowledges that the word ‘incur’ involves an element of choice, he recognised certain difficulties of the interpretation of the concept of when a debt is incurred. Although Hodgson J’s interpretation may shed some light on the scope of when a debt is incurred, subsequent judicial decisions seem to discount that view. In \textit{Shepherd Australia & NZ Banking Group} (1996) 14 ACLC 987 at 992, Bryson J asserted that: “There is no purportedly exhaustive judicial exposition of what is meant by ‘incurred’ in s 588G(1)(a)...” The significance of these decisions is that they relate to a critical aspect of the operation of s 588G yet, they pose problems of reconciliation. Some available literature as to what is meant the term ‘incurs a debt’ under s 588G include: Noble, “When Does a Company Incurs a Debt under the Insolvent Trading Provisions” (1994) 12 C &SLJ 297,297; Mosely, “Insolvent Trading: What is a Debt and when is One Incurred?” (1996) 4 Insol LJ 155, 155; A. Herzberg, “Insolvent Trading-Civil Liability of Company Officers under Insolvent Trading Provisions” (1991) 9 C&SLJ 285, 286.

\textsuperscript{118} Su –King Hii, “Directors’ Duties to Prevent Insolvent Trading”. (1999) 27 ABLR 224, 231. In order to avoid liability, the directors may poorly misconstrue the term incurs a debt and feel the pressure to cease business before the company becomes insolvent, which under certain circumstances brings about premature liquidation.
8.3.3. Creditors Protection (Insolvent Trading)

Insolvent Trading Provisions do not provide Unqualified Protection to Creditors.

This argument is based on the s 588V holding company-subsidiary liability. The supposition that s 588V protects creditors and renders some justice and fairness to them generally has been questioned. The question advanced is whether s 588V encourages holding companies to monitor their subsidiaries so as to ensure that they do not contract with creditors whilst insolvent. Ramsay argues that while s 588V satisfies the efficiency criteria, the scope of the section is limited in the sense that it provides only a particular solution to the problem of holding company unaccountability for the debts of insolvent subsidiaries. Accordingly, s 588V is deficient in that it provides no protection for all claimants of insolvent subsidiaries. This argument at least to an extent is correct. When insolvency approaches, the existence of corporate groups exacerbate the excessive risks taken by shareholders thereby concealing the true financial position of individual companies from creditors.

In addition, where a company in a corporate group is in financial difficulties, managers may move assets from that company to other companies in the group that have a better chance of survival—at the expense of creditors. This problem can easily be resolved by having recourse to the concept of a ‘shadow director’. One means of establishing holding company liability for the debts of the subsidiary is where the holding company can be held to be a shadow director of the subsidiary. Accordingly, ss 588G-Q imposes personal liability upon a director of a company where the company has engaged in insolvent trading. The definition of director in section 60 of the Corporations Act includes the concept of shadow director and it can include a holding company.

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120 Ibid.
121 Tort claimants are the least likely of all dealing with a company to be able to contract to protect themselves against harmful behavior or action by a company. Therefore, s 588V is an inadequate response to this problem. The s 588V provision aside, when a company goes into insolvency and directors are ordered by the court to make compensation to the company, unsecured creditors may receive no protection especially where there may simply be nothing left to collect from directors when proceedings are brought against them. Since the financial status of the individuals who run companies is usually closely tied to the fortunes of the business, directors of failed companies often do not have substantial personal assets. They may well not have the means required to satisfy any order obtained against them (This position also lend support from A. Hicks, “Advising on Wrongful Trading: Part II” (1993) 14 Co Law 16, 17.
122 The establishment of undercapitalized subsidiaries to conduct asbestos mining is an apparent example illustrated in Briggs v James Hardie & Co Pty Ltd (1989) 7 ACLC 841. See also, Walker v Wimbborne (1976) 137 CLR 1.
123 See, for example, H. Collins, “Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration” (1990)53 MLR 761, 771. Different approaches in comparable jurisdictions governing the liability of
8.3.2. **Contractual Covenants (Loan & Debt Covenants)**

The ‘asset maintenance’ safeguards just analyzed in the previous discussion, stopped short of adequately addressing, issues concerning the protection of secured creditors and the problem of conflicts of interests arising from share capital transactions. Some lawyer-economists, using a ‘hypothetical bargain heuristic’ model based on market conditions, argue that, since the capital maintenance rules do not accord with the likely terms which creditors would want, contractual terms such as loan and debt

holding companies for the debts of their subsidiaries does not suggest they outweigh the $588G’s unique approach. One method, by which European Union Members and the US regulate holding company–subsidiary debts, is by piercing the corporate veil. (See, K. Hofstetter, “Parent Responsibility for Subsidiary Corporation: Evaluating European Trends” (1990) 39 Int & Comp Law Q 576, 590; R.B. Thompson, “Piercing the Corporate Veil: An Empirical Study” (1991) 76 Cornell LR 1036). A review of the law in comparative jurisdictions governing the liability of holding companies for the debts of their insolvent subsidiaries remains imprecise and uncertain. This therefore suggests that the $588G’s unique approach remains more accommodating. Because, $588V removes the limited liability that would otherwise apply between a holding company and its subsidiary where the subsidiary has engaged into insolvent trading and the holding company either was aware or should have been aware of this. To protect tort creditors, $588G can also be structured in the way that this group of creditors can be given priority over some financial creditors. (These views lends support to P. I. Blumberg, “Limited Liability and Corporate Groups” (1986) 11 JCL 573, 662; D.W. Leebron, “Limited Liability, Tort Claimants and Creditors” (1991) 91 Col LR 1565, 1643).

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124 See, C.W. Smith & J. Warner, “On Financial Contracting, An Analysis of Bond Covenants” (1979) 7 JFE 117, 119 who identified four major sources of conflicts which arise between bondholders and stockholders. These include: (i) Dividend payments if firm issues bonds and the bonds are priced assuming the firm will maintain its dividend policy, the value of the bonds is reduced by raising the dividend rate and financing the increase by reducing investment. At the limit, if the firm sells all its assets and pays a liquidating dividend to the stockholders, the bondholders are left with worthless claims; (ii) claim dilution—that is, shareholders can act opportunistically by issuing additional debts of the same or higher priority, thereby eliminating the advantage of existing creditors’ claims on the company’s assets if the company becomes insolvent; (iii) asset substitution (By this is meant shareholders can make distributions to themselves in the form of dividend payments, share repurchase and excessive salaries. All of these distributions reduce the equity cushion upon which creditor’s depend when they extend credit to a company; (iv) underinvestment.

125 This argument is similar to mainstream economists who model markets by explaining a variety of terms used in debt instruments as contractual mechanisms that address agency problems. Economists divide corporate agency theory into financial and managerial agency problem. The first category, assumes that managers are perfect agents of their principal, the shareholders. Unless constrained, those managers make decisions that enrich their shareholders at the expense of the firm’s creditors. They may distribute firm’s assets to shareholders through dividends, share redemptions or buy-back. The second category arises from the conflict between the self interests of management vis-à-vis shareholders and, between shareholders. Unless constraint, managers have the incentive to increase their compensation and to cut back on their efforts on behalf of the company. They also have incentives to expand the size of the corporation and to secure their position by building cushions of free cash or liquid assets (that insulate the firm from capital markets and financial distress. See, for example, C.W. Smith & J. Warner, “On Financial Contracting, An Analysis of Bond Covenants” (1979) 7 JFE 117-161; B.R. Adler, “An Equity-Agency Solution to the Bankruptcy Priority Puzzle” (1993) 22 J Legal Stud 73; G.G. Triantis, “A Free-Cash Flow Theory of Secured Debt and Creditor Priorities” 91994) 80 Va LR 2155.

126 There are various kinds of contractual measures which creditors may adopt in order to diminish the risk associated with corporate borrowers. The most common in large scale financing transactions are the loan or debt covenants. (Generally referred to as bond covenants). Lawyer economists however grouped observed covenants into four categories which include: (i) production and investments covenants, (ii) Dividend covenants; (iii) financing covenants and (iv) bond covenants. See, generally, C.W. Smith & J. Warner, “On Financial Contracting, An Analysis of Bond Covenants” (1979) 7 JFE 117-161; M. Kahan, “The Quantified Case Against Mandatory Terms in Bonds” (1995) 89 Northwestern ULR 565, 566, 595-60; M. Eisenberg, “The Structure of Corporate Law” (1989) 89 Col LR 1461, 1530, 1543; P. Asquith, A. Thierry, “Evident Risk, Covenants and Bondholders Returns in LBO’s” (1990) 27 JFE 195; S.C. Myers, “Determinants of Corporate Borrowing” (1977) 5 JFE 147, 158; V.
covenants" would easily explain the lender’s choice as an efficient contractual response to agency cost. The bond covenants (i.e., loan and debt covenants) in the broadest of terms are legally enforceable contracts between the shareholders (through the agency of the company) and creditors, by which the shareholders agree not to do certain things which would be contrary to the interest of the creditors. These may include a covenant not to undertake any superior or equal ranking debt; a covenant not to increase the leverage of the corporation beyond a certain pre-specified level or a covenant linking the interest payable under the debt contract with the company's leverage ratio or some other measure of its financial position. Aside from the issue of conflicts of interest which loan and debt covenants could address, these covenants are also one of the various sophisticated means by which secured creditors could adequately protect themselves.


128 A loan covenant is a term in a loan agreement which is not related to the repayment of interest or capital, but rather relates to the borrowers conduct during the course of the loan. Proponents using loan and debts covenants in mitigating conflict of interest between shareholders and creditors and for the protection of secured creditors argue that the types of covenants found under legal rules or mandatory provisions to control share capital transactions (such as restriction on dividends to profits, limitations on buy-back, reduction of capital and financial assistance) are not a positive response of addressing externalities and agency costs. Using empirical findings, they argue that the potential drawback with a mandatory term is that they are inferior to a contractual term, even if the contractual term is not perfectly efficient they nevertheless provide a high level of protection and efficiency to creditors. (See, generally, C.W. Smith & J. Warner, (ibid); M. Kahan, (ibid); M. Eisenberg, “The Structure of Corporate Law” (1989) 89 Col LR 1461; 1530, 1543; Asquith, A. Thierry, “Evident Risk, Covenants and Bondholders Returns in LBO’s” (1990) 27 JFE 195; J.C. Duke & I.G. Hunt III, (Ibid).

129 The rationale for the existence of bond covenants reveals that if dividend decisions, share repurchases and other payments and distributions to shareholders of levered firms are constrained, creditors in general will be protected. This approach finds support in the U.S where the maintenance of capital rules is not so deeply rooted. It further supported in financial literature—see, B.R. Cheffins, (1997) at 6; Jensen & Meckling, below n 154, 305; A. Poulsen, “Contractual Resolution to Bondholders-Stockholder Conflicts in Leveraged Buy-outs” (1991) 34 J Law & Econ 645, 654-657. A bond covenant restricts a company’s ability to incur additional debt, or to pay dividends to shareholders; set conditions for mergers, share-buy backs and defines when a company is in default.


130 The term “bond” is commonly used either as a catchall term for different debt securities) (e.g., notes and debentures). It is more narrowly used for a debt instrument secured by collateral such a mortgaged bond (M. Kahan, above n 126.

131 In the previous discussion, it was argued that insolvent trading provisions could only primarily protect unsecured creditors, it is therefore suggested in this part of the study that secured creditors could opt in and out around contracts and other covenants to protect themselves. The contractual agreements often arrived at between the company and creditors apart from enforcing the provisions by a solvency or bankruptcy court, often require an
Bonds which are among the most important sources of capital for American companies are in the form of provisions containing terms which include debt limitations, dividend limitations; restrictions on mergers and asset sales; provisions relating to maintenance of property, maintenance of net worth, investment restrictions, assets dispositions and other payments and distribution restrictions.  

Though shareholders can benefit themselves at the expense of creditors by engaging in the types of behavior described above, it has not been shown how the capital maintenance provisions could be used to mitigate such opportunist behavior or even afford creditors the opportunity to benefit themselves at the expense of the shareholders by engaging in similar behavior. Empirical research on U.S lending agreements suggests

independent trustee to represent the bondholders, by acting as an agent in covenant enforcement for the debts of the creditors or bondholders. This mechanism is known as a ‘corporate trust indenture’, which specifies the respective rights and obligations of the firm, the individual bondholders and the trustee. Where a firm’s debt is not held by a single borrower a number of problems relating to enforcement of the debt contract by a trustee arise. For example, any individual’s holdings of the firm’s debt may be so small that no single bondholder has much incentive to expend resources in covenant enforcement. The company’s owners offer a contract which appoints a trustee to help assure that the optimal amount of covenant enforcement will take place. Having the firm pay the trustees directly solves the ‘free-rider’ problem which will be inherent in making individual bondholders pay the trustee for enforcing the covenants. It is to be noted that indenture trustees are large banking institutions restricted by both trust and contract law. Publicly issued debt obligation must also only comply with the requirements of the Trust Indenture Act 1939 (“TIA”) (as amended by the 1988 Act). For an elaborate discussion of the enforceability of covenant provisions, see, J. C. Kennedy, Corporate Trusts Administration, (New-York: NYUP, 1961) 33-49.

M. Kahan, above n 126, 587; Smith & Warner, above n 126, 117. These commentators suggest that contracts between debt-holders and stockholders (owner-managers) contain covenants that restrict management behavior because, owner-managers have incentives to take actions that may negatively affect the debt-holders wealth position. These covenant constraints are assumed to generally protect creditors by requiring the maintenance of assets. By limiting the firms operating decisions and requiring the firm to invest in particular projects and hold particular assets (such as covenants requiring the firm to maintain its working capital-current assets less current liabilities, maintenance of a cash flow and working capital above a certain minimum level), it is assumed that corporate transactions such as mergers, buy-backs, dividend distribution that violate any covenants provides a signal to the lender. (Smith & Warner, above n 126 at 135; Kahan, above n 126 at 587-588).

Capital maintenance rules may be understood to some extent to assist creditors by supplying ‘term’ into bargains between creditors and shareholders. Such as restricting dividends to profits found under s 254T. However, because these ‘terms’ are haphazardly implemented and the share capital restrictions are set historically, they do not serve to be strong enough reducing the risk of default for example, a creditor who lends money to a company several years after it has been incorporated. If subsequent creditors want to have restrictions on distributions, then they are free to bargain for them by contract. Such contractually agreed provisions are indeed commonly observed, and far more likely to be tailored to the needs of creditors than statutorily imposed ones. Whilst the statutory imposed insolvency trading provisions found in s 588G may assist to this effect, they however protect only unsecured creditors, leaving secured creditors to have recourse to other self protecting means like loan covenants and other sophisticated means. (Generally, see, J. Armour, “Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law” (2000) 26 MLR 355, 356-7; Cheffins, above n 89, 533). It might also be possible to suggest that one economic rationale of the capital maintenance regime serves to reduce financial agency cost-the costs of conflict of interests between shareholders and creditors. (This rationale is in accordance with the traditional understanding of lawyers that the maintenance of capital rules is to do with “creditor protection). (See, Trevor v Whithworth (1887) 12 App Cas 409, 423-424 per Lord Watson. See also S. C. Myers, “Determinants of Corporate Borrowing” (1977) 5 JFE 147, 175). However, it is a different proposition to saying that the rules found
that if shareholders and creditors enter into contractual agreements in the form of covenants and bond indentures, at the onset of the lending agreement, the covenants would directly restrict distributions and payments such as dividends & buy-backs by placing an implicit constraint on the investment and financial policy of the company, providing the stockholders and management with incentives to follow a firm-value maximizing production and investment decision and control conflicts of interest.\textsuperscript{134} When bondholders exercise a significant but reasonable degree of control over the company’s financial structure and, are given the relevant remedies available in their contract with the company their protection is greatly strengthened.\textsuperscript{135}

8.3.2.1. Advantages and Role of Bond Covenants.

8.3.2.1.1. Protect Secured and Unsecured Creditors.

Covenants are intended to prevent a corporation from taking actions that benefit shareholders at the expense of bondholders. The typical lending process of loan covenants will involve the lender investigating the creditworthiness of the prospective borrower before the loan is made and imposing contractual restrictions which are intended to ensure that the borrower’s creditworthiness is not materially eroded during the life of the loan. Contracting has two parts. First, lenders may charge a high interest rate on the loan that is negotiated between the creditor and the company which

\textsuperscript{134} For example, to the extent that fixed claimants control or exert a controlling influence over the company to which they have loaned money, such claimants can divert assets by forcing the company to prepay loans or decline to pay dividends. Fixed claimants can also engage in equity claim dilution by forcing indebted companies to issue additional equity in order to pad their equity cushion. Fixed claimants can require the company to pursue less risky projects than the shareholders had envisioned when they invested, thereby increasing the value of the firm’s claims at the expense of the shareholders claims. Empirical findings further prove that restrictions on distributions through loan covenants can reduce the likelihood of transactions which increase the risk of default on a firm’s debt obligations more effectively than any restrictions imposed by legal capital doctrines. (See generally, R. Posner, “The Rights of Creditors of Affiliated Corporations” (1976) 43 U Chi LR 499, 504; G. Gulati et al, “Connected Contracts” (2000) 47 UCLA LR 887, 908-918; Peterson & Hawker, “Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions” (1997) 31 Akron LR 175-227). Arguably, the above mentioned covenants do not completely control all conflicts between shareholders and creditors. However, they tremendously ameliorate the conflicts and reduce the risk of default especially where adequate enforcement mechanisms are in place and at a reduced cost. Covenants in general frequently restrict the freedom of corporate borrowers to distribute assets to the shareholders more effectively than the restrictions provided under legal rules. They also do so, in a more sophisticated and comprehensively way than capital maintenance provisions do. (See, Smith & Warner, above n 146 at 1311-135; Enriquez Macey, (2001) 86 Col LR 1165, 1170).

\textsuperscript{135} Relevant measures of control will include seizure of collateral, acceleration of the maturity of the debt; the right of the lender to put the company into legal and bankruptcy proceedings. (See M.H.Douglas, “Creditors Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor” (1975) 31 Bus Law 343-65
can be expected to reflect the risks that the lender faces. Second, the contract may contain restrictions on the activities of the company.\textsuperscript{136}

8.3.2.1.2. **Reduced Bonding Costs**

Meckling and Jensen, argue that the use of bond covenants in corporate transactions reduces the associated cost of conflicts between the various different parties in the transaction. According to them, cost is reduced when potential bondholders estimate the costs associated with monitoring the firm to assure that the bond covenants have not been violated and the estimate is reflected in the price when the bonds are sold.\textsuperscript{137} They take the view that since the value of the firm at the time the bonds are issued is influenced by anticipated monitoring costs, it is in the interests of the firm’s owners to include contractual provisions which lower the costs of monitoring. For example, observed provisions often include the requirement that the firm supply audited annual financial statements to the bondholders.\textsuperscript{138}

8.3.2.1.3. **Reduces Conflicts of Interests.**

Generally, distributions and payments by corporations to shareholders (in the form of dividends, share repurchase, redemption of shares, financial assistance) are likely to cause a conflict of interest between shareholders and general creditors of a company.\textsuperscript{139}

\textsuperscript{136} With loan covenants, creditors are protected from corporate distributions and payments to shareholders if the state can supply an opt-in ‘menu’ of covenants, from which limited companies could insert provisions to become ‘collective terms’. With this approach, some companies would want to offer creditors particular covenant-like restrictions although, others would want to avoid this by leaving the matter purely to market contracting. See, R Sappidean, “Protecting Debenture Holder Interests: A Delicate Art” (1991) 4 Corp & Bus Law J 36; M. Klausner, “Corporations, Corporate Law, Networks of Contracts” (1998) 81 Va LR 757, 756; R. K. Rasmussen, “Debtor’s Choice: A Menu Approach to Corporate Bankruptcy” (1992) 71 Tex LR 51.

\textsuperscript{137} W.H. Meckling & M.C. Jensen, “Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure” (1976) 3 JFE 305-360. The argument that covenants reduce bonding cost may not often be the case because negotiating and drafting contractual clauses which are binding on all creditors may not only be time consuming but also, costly and the enforceability of such arrangements in the courts would probably be open to question.

\textsuperscript{138} Bond covenants require the company to supply financial and other information to creditors for as long as the debt is outstanding. These include all financial statements, reports and proxy statements which the firm already sends to its shareholders, reports and statements filed with the security exchange commission; quarterly financial statements certified by a financial officer of the firm and financial statements for the fiscal year audited by an independent public account. It is then suggested that bondholders will find such financial information very useful in deciding whether to lend or not. Meckling and Jensen call these expenditures by the firm, ‘bonding costs’. And suggest that, so long as the company supplies this information at a lower cost, it pays the company’s shareholders to contract to provide this information because the market value of the firm increases by the reduction in agency costs. (Jensen & Meckling (Ibid), 338. See also, R. Watt, “Corporate Financial Statements, A Product of the Market & Political Process” (1977) 2 Aust J Mgmt 53-75.

\textsuperscript{139} Shareholders generally expect a return on their investment as an enterprise earns profits, while creditors desire that an enterprise have substantial assets available for so long as their claims have not been paid. A possible response
Since legal rules may not adequately address the conflict of interest problems generated by corporate share capital transactions and because, such rules do not effectively mitigate information asymmetry problems, economists suggest that it is rationally possible for creditors to spend money writing contractual prohibitions (such as loan covenants) on wealth reducing activities to control the borrower's action.\textsuperscript{140} Observed debt covenants are structured to control the conflict of interest between bondholders and stockholders.\textsuperscript{141} The ingenuity with which loan contracts are written indicates the strong economic incentives for the firm's owners to lower the agency costs which can result from having risky debt in the firms' capital structure. The existence of standardized debt contracts suggest that the out-of-pocket costs of drafting observed bond covenants are small indeed.\textsuperscript{142}

Because creditors contract in 'parallel', the debtor's freedom of action is determined by the most restrictive covenant to which it is subject and which is enforced. Creditors can therefore free-ride on each other's investment in contracting, monitoring and enforcement with the result that each invests less than would be collectively justified.\textsuperscript{143} Generally, while small firms may be able to reduce this problem by concentrating a large part of their external finance with a single creditor such as a bank, the frequent use of 'cross default clauses' suggest that creditors of large firms do indeed attempt to free ride in this way.\textsuperscript{144}

Considering the nature of both financial and managerial agency problems, creditors are concerned about decisions of directors that transfer wealth from creditors to either shareholders or managers (referred to collectively as 'misbehavior'). Because managers have cash at their disposal, it is assumed that by imposing bond covenants which impose

\textsuperscript{140} See, Jensen & Meckling, above n 137, 334-343; Smith & Warner, above n 126, 117; G.G. Triantis, above n 146, 2155-2158. These writers suggest that these covenants can be explain as the party's best efforts to reduce the costs of lender-borrower conflicts of interests. This is further supported by studies which show that both the prevalence and restrictions of loan covenants increase with the debtor's ratio of debt-to-equity.

\textsuperscript{141} A. Kalay, "Stockholder-Bondholder Conflicts of Interest and Dividend Constraints" (1982) 10 JFE 211, 211.

\textsuperscript{142} Smith and Warner, above n 146, 152-154.

\textsuperscript{143} Saul Levmore, "Monitors & Free riders in Commercial & Corporate Settings" (1982) 92 YLJ 49, 53-54.

\textsuperscript{144} P.R. Wood, "Term Loan Agreements: A Guide to Basics, Part 3" [1996] Comm Law 51, 52 (who defines 'default' to include a breach of any other loan covenant).
fixed payment obligations on the firm, debts remove free cash from the reach of
directors.\textsuperscript{145} Under the economic test of allocative efficiency, to address the overzealous
conflicts of interest problems caused by transactions affecting share capital\textsuperscript{146} the
application of the loan covenants as mechanisms imposed into lending agreements, will
reinforce the protective mechanisms suggested in this chapter by reducing the moral
hazards and externalities which legal rules failed to adequately mitigate.\textsuperscript{147}

8.3.2.1.4. \textbf{Control Managerial Conduct.}

Loan covenants act as a control on managerial ‘misbehavior’. U.S. creditors habitually
include loan covenants in large scale lending agreements which restrict distributions,
return of capital and other payments to shareholders.\textsuperscript{148} A typical lending process will
involve the lender investigating the credit worthiness of the prospective borrower before
the loan is made and imposing contractual restrictions (covenants) on management,
intended to ensure that the borrowers’ equity is not eroded during the life of a loan.
Through pre-lending investigation, the imposition of covenants in the terms of the loan
and compliance checks whilst it remain outstanding, lenders thus perform a monitoring
function which is valuable to shareholders in that it serves as a form of guarantee of
managerial diligence.\textsuperscript{149}

Though a debt contract can place restrictions on managerial conduct-such as the
imposition of covenants which require the company to comply with designated financial


\textsuperscript{146} See, Corporations Act 2001 (Cth), sections 254T, 256, 257 and 260.

\textsuperscript{147} This approach finds support to ‘covenant theorists’ such as, Smith & Warner, above, n 126, 117 and all other
references and the texts preceding them. While loan or debt covenants may presumably ameliorate conflicts of
interests and protect secured creditors, they are not likely to be a positive response for the protection of
involuntary creditors such as tort claimants, trade creditors and employees) who lack the means of contracting.
Even sophisticated creditors cannot foresee all contingencies and contract for protection against them. Significant
corporate restructurings, such as leveraged buyouts have seen transfers of wealth from sophisticated creditors.
A leverage buy-out occurs where existing shareholders of a company transfer control of the company to an outsider.
A high level of debt is then used to fund the acquisition. Because this debt will be serviced by the acquired
company (by cash flows of the business or by disposal of assets), this increases the risk of existing creditors of the
company not being paid. (See, Bratton, “Corporate Debt Relationships: Legal Theory in a Time of Restructuring”
creditors’ (such as unsecured creditors) since they can take advantage of lenders who impose a restriction on
distribution to shareholders and who monitor the borrower to ensure compliance. According to this view, even if
only one sophisticated creditor has imposed such covenants on a corporate debtor, all of that company’s creditors
will gain protection from wrongdoing (at 53-54).

\textsuperscript{148} Smith & Warner, above n 126, 135.

\textsuperscript{149} Ibid, 111.
ratios and to remain in the same line of business, there are contractual gaps. Arguably, bargaining is not a perfect solution for creditors. The types of conduct which might adversely affect their interests cannot all be addressed since some are very difficult to anticipate. Even with predictable contingencies, drafting provisions which deal effectively with the risks involved can be difficult and expensive. It is argued that some debt agreements such as those involving trade creditors impose few if any substantial restrictions on managerial behavior.

8.3.3. Oppression Remedy Provisions.

8.3.3.1. Statutory Application

The oppression remedy provisions contained in sections 232-234 of the Corporations Act, are intended to have general application. They are concerned in addressing the various legal procedures which result in the compulsory acquisition of minority shareholdings by the majority, or the extinction of the minority shareholdings through other corporate transactions such as the cancellation of their shares under a selective buyback and reduction of capital, leaving the majority in absolute control.

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150 B. Cheffins, above n 128 at 81.

151 The position of trade creditors illustrates the limitation involved with bargaining for protection. Trade creditors often resort to other self-protection such as relying on retention of title clauses ("Ramalpa clauses")—well illustrated in Aluminaum Industrie Vaassen BV v Romalpa Alumininum [1976] 1 WLR 676. (See also the discussion by, W. Bull, "Implicit Contracts in the Absence of Enforcement and Risk Aversion" (1983) 73 Am Rev 658. It is also argued that even debt contracts which deal with managerial conduct are unlikely to address all contingencies since creditors will never have perfect information about the types of managerial conduct which could affect the financial status of borrowing companies. (See also, B. Cheffins, above n 128 at 541) (Arguing that at some point, the costs associated with negotiating about particular practices will exceed the benefits).

152 A number of general definitions of 'oppression' or 'oppressive conduct' have been adopted by the judiciary and the legislation. These include 'burdensome', 'harsh' and 'wrongful' (D.C. W.S. v Meyer [1959] AC 423 per Viscount Simmonds); 'an element of lack of probity and fair dealing' (Elder v Elder & Watson Ltd [1952] SC 49 at 60 per Lord Keith and more recently by the Corporations Act 2001, as 'oppressive, unfairly prejudicial or unfairly discriminatory' (ss 232-234). For purposes of this study, the later view will be used and, the oppression remedy regime will be used exclusively for the protection of those shareholders whose interest in the corporation has been threatened by the conduct of the corporations' affairs. Those adversely prejudiced shareholders will be collectively known as 'minority shareholders' (who may include any person with a minority status such as shareholders, employees). Empirical study shows that minority shareholders are amongst the group of shareholders vulnerable to oppression because they are forcibly eliminated from the company. Empirical evidence further suggest that those evoking the oppression remedy are minority shareholders, especially those of small private companies or closely held companies (I. Ramsay, "An Empirical Study of the Use of the Oppression Remedy" (1999) 27 ABLR 23.

153 The majority control suggests some financial and economic advantages of eliminating minority shareholdings. Such benefits include; facilitating financial restructuring, permitting the transfer of tax losses between wholly owned group companies; reducing administrative and reporting costs; avoiding greenmailing, eliminating possible conflicts of interest in partially owned companies. (See Legal Committee of the Companies and Securities Advisory Committee, Report by the Legal Committee on Compulsory Acquisitions (Jan 1996) at 6. For some extensive literature on the oppression remedy generally, see the following: I. Ramsay, "An Empirical Study of the
Chapter 8  8.3. Shareholder Protection (Oppression Remedy Provision)

The remedy enlarged the scope for a member to have the acts of managers and controlling shareholders reviewed. It does not require the conduct complained of to be unlawful and, it allowed proceedings to be instituted by an individual member despite the rule in *Foss v Harbottle*. With the demise of that rule, modern legislation reflects a change in attitude, to counter defective minority protection. Generally, the high level of share ownership concentration makes problems between controlling and minority shareholders the crucial axis of agency conflict.

The Corporations Act uses the various provisions under ss 232-234 of the oppression remedy regime as an alternative mechanism of protecting shareholders from share capital transactions which may adversely interfere with their interests and to address conflicts between shareholders. Generally, while the capital maintenance doctrine was concerned with creditor protection, the doctrine also seeks to ensure that minority shareholders are not prejudiced through share capital transactions.

Sections 232 (a-e) inclusive, allow courts a discretion to grant relief to a wide range of unfair conduct. The provisions provide a statutory means whereby corporate shareholders may gain redress for corporate conduct which is either contrary to the interests of the members as a whole; or oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members whether in that capacity or in any other capacity.

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154 *Re Associated Tools Industries Ltd [1964] ALR 73. Traditionally, company law and the capital maintenance doctrine did not show much concern for the interests of shareholders, especially minority shareholders or where they did, the rule in *Foss v Harbottle* (1843) 2 Hare 461 presents a stumbling block.*

155 *From a minority shareholder perspective, proposals or restructuring of the company appear oppressive or otherwise unfair or, simply an illegitimate interference with their property rights (Ford et al, above n 3 para 24.190 at 1036. Accordingly, when a company pursues any corporate activity that may threaten its share capital or the propriety and other interest of shareholders, there can be a serious risk of conflict. For example, a dispute among shareholders vis-à-vis management or between shareholders per se, may generate in the majority oppressing the minority.*

156 *The mischief which section 323 is intended to cure concerns the case of abuse of power by directors and controlling shareholders. The safeguards provided by the legislation may be considered a crucial weapon in addressing perceived injustices caused to minority shareholders.*

157 *See for example, Scottish Insurance v Wilson & Clyde Coal Co [1949] AC 462; Re Old Silkstone Collieries Ltd (1954) 1 All ER 68. Where a question in issue was whether a reduction could vary and abrogate the rights of minority shareholders prejudicial to their interest.*

158 *Examples of conduct which the courts have found to be oppressive include: payment of excessive remuneration to a controller or associate (see, *Sanford v Sanford Courier Service Pty Ltd* (1987) 10 ACLR 549 at 557); unfairly restricting dividends (*Re C G Jeffry (Mens Store) Pty Ltd* (1984) 9 ACLR 193); improper exclusion from participation in management (*Quinlan v Essex Hinge Co Ltd* [1996] 2 BCLC 417); misstatements and omissions
In Fexuto Pty Ltd v Bosnjak Holdings Pty Ltd, Speigelman CJ said:

The statutory formulation has been extended over the years to confer on the court a wide-ranging remedial jurisdiction. The addition of the words ‘unfairly prejudicial to’ and ‘unfairly discriminate against’, to the original statutory reference to ‘oppressive’, indicates an intention that the jurisdiction should not be confined by technical distinctions.\(^{159}\)

The scope of the of the word, “unfairly prejudicial” was considered by the House of Lords in O’Neill v Phillips,\(^{160}\) where Lord Hoffmann (with whom other members of the House agreed) took the view that ‘unfairness’ may consist in a breach of the agreed rules between members or in using the rules in a manner which equity would regard as contrary to good faith. This formulation leads to the so called “legitimate expectation” test. The test was used in Re Saul D Harrison and Sons Plc,\(^{161}\) as a label for the ‘correlative right’ to which a relationship between company members may give rise in a case when, on equitable principles, it would be regarded as unfair for a majority to exercise power conferred upon them by the company’s constitution to the prejudice of another member. In Office Suppliers Ltd & Ors v Shaun Larvin\(^{162}\), the respondent, a shareholder and director of the appellant company who was prevented from having access to the company’s records, alleges that the affairs of the company had been conducted by his fellow shareholders and directors in a manner unfairly prejudicial to his interest. Blackburn J held that the petition was well-founded and, ordered that the company purchase the respondents shares at one third of the valuation of the company at the date of hearing.

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\(^{159}\) by directors in breach of fiduciary duty (i.e., conduct involving breach of directors’ duties might readily be made the subject of a claim for relief under s 232); use of company funds to defend oppression proceedings (Re D G Brins & Sons Pty Ltd (1995) 16 ACSR 559). A number of foreign jurisdictions have comparatively similar oppression provisions to that of the Corporations Act. See, for example, Company’s Act 1985 (UK), ss 459-461 (as amended by Shed 19, Para 11 of the Company’s Act 1989, s 145). Section 461 states: “If the court is satisfied that ... the application is well founded, it may make such orders which include regulating the future conduct of the company’s affairs, requiring the company to do or refrain from doing some act and, providing for the purchase of the petitioner’s shares by other members of the company itself.” See also, Companies Act 1993 (NZ), s 174; Canadian Business Corporations Act (“CBCA”) 1990, ss 241-243.

\(^{160}\) (2001) 37 ACSR 672. Also, in Thomas v H.W. Thomas Ltd [1984] 1 NZLR 684, Richardson J thought the various terms, ‘oppressive conduct’, ‘unfairly prejudicial and unfairly discriminatory conducts’ were not distinct alternatives to be considered separately in watertight compartments and that the statutory concern was directed to instances or courses of conduct amounting to an unjust detriment to the interest of a member (s) of the company. He submitted that there could be cases where relief could be given without the applicant having to show invasion of his or her own rights or demonstrating a lack of probity or want of good faith towards him or her.


\(^{162}\) [2002] EWCA Civ 1740.
According to the oppression remedy provisions, if the conduct of the corporation is oppressive, unfairly prejudicial to or unfairly disregards the interest of corporate shareholders, the court may impose a ‘fit order’. The nature and scope of that order is circumscribed by the requirement that the order rectify the matter complained of and addresses only the aggrieved parties’ interest.\textsuperscript{163} By providing for remedies against individuals, including directors with minority shareholder status, s 232 recognizes that the rectification of harm done to corporate stakeholders by corporate abuse may necessitate an order against individuals through whom the company acts. To the extent that the provisions contemplate that individuals will bear the remedial burden flowing from the oppressive exercise of corporate powers, s 232 takes a different approach of assigning responsibility for corporate conduct than the common law. The section permits the court to address the harm done by the conduct described in s 232 from a broader perspective than that permitted by a simple enquiry into the true identity of the actor.

In \textit{Wayde v NSW Rugby League Ltd}, Brennan J explained the concept of oppression thus:

\begin{quote}
The concept of oppression may be measured by reference to the conduct of reasonable directors, possessing any special skill, knowledge or acumen possessed by the directors and having in mind the importance of furthering the corporate object on the one hand and the disadvantage, disability or burden which their decision will impose on a member on the other.\textsuperscript{164}
\end{quote}

Sections 233 (1) (a-j) inclusive, contain many examples of orders for relief which the court may make. The court has discretion to make such order(s) as it thinks appropriate. The breadth of the oppression provisions and the range of flexible orders a court can make when it finds oppression has occurred means that it is one of the most widely used corporate law remedies available to shareholders.\textsuperscript{165} Relief under this section includes: winding-up a company, regulation of the conduct of the company’s affairs in the future.\textsuperscript{166}


\textsuperscript{164} [1985] 189 CLR 459

\textsuperscript{165} See, I. Ramsay, above n 153, 23.

\textsuperscript{166} \textit{Corporations Act 2001} (Cth), s 33 sets out a guide as to what is meant by the affairs of the company. This section is not exclusive in its coverage and the concept may be very wide. For example, in \textit{ASC v Lucas} (1992) 36 FCR 165, Drummond J held that the internal procedures of an auditing form are included as being ‘affairs of the body corporate’. If this view is correct, then, as concerns related companies, the Lucas case may catch the affairs of the parent company which include the business of a wholly owned subsidiary. See also, \textit{Scottish Coop Wholesale Society Ltd v Meyer} 1959] AC 324. But cf. \textit{Morgan v 45 Flers Avenue Pty Ltd 91986] 10 ACLR 692 where
an order for the purchase of any shares by any member or person to whom a share in the
corporation has been transmitted by will or by operation of law; an order for the purchase of
shares with an appropriate reduction of the company’s share capital; authorizing a
member to whom a share in the company has been transmitted by will or by operation of
law, to institute, prosecute, defend or discontinue specified proceedings on behalf of the
corporation; appointment of a receiver or receiver manager of all of the company’s property
and restrain a person from engaging in specified conduct or from doing a specified
act.\textsuperscript{167}

These remedial provisions inclusive serve as a judicial brake against abuse of corporate
power, particularly, but not exclusively, by those in control of corporations and in a
position to force the will of the majority on the minority. Section 233 enables the court to
intercede in the affairs and operation of a corporation and to effectively override the
decisions of those charged with the responsibility of corporate governance\textsuperscript{168}. Where
share capital transactions materially prejudice the interests of the company’s shareholders
as a whole, any shareholder(s) whose interests has been so threatened by the
corporation’s conduct, is given powers under s 234 to take proceedings and the court may
make the necessary orders under s 233 if the application is successful.\textsuperscript{169}

\textsuperscript{167} Young J was unwilling to find that the conduct of directors of a subsidiary could be construed as conduct in the
affairs of the parent company, despite the parent company appointed the directors.

\textsuperscript{168} These court remedies are well illustrated in Acohill Investment Pty Ltd v Inmetric Ltd (No 2) 2002 SASC 406; 

\textsuperscript{169} It is worth noting that the action for oppressive conduct can be against directors for breach of fiduciary and
statutory duties but also against majority shareholders under the “equitable limitation” principle. To this effect see,
Allen v Gold Reefs of West Africa Ltd [1900] 1 Ch 659 where a typical generalized fiduciary duty was imposed on
shareholders where it was believed the minority were prejudiced as a result of the conduct both of directors and
controlling shareholders. Minority shareholders may encounter difficulties trying to pursue transactions conducted
by nominee directors appointed to a subsidiary. In Morgan v 45 Fleur Avenue Pty Ltd (1986) 10 ACLR 692, the
court dismissed a suit by a plaintiff for raising the oppression remedy against a nominee director. This ruling
might have been influenced to the fact that a person in the status of a nominee director, may legitimately exercise
his/her votes on a board in the interests of the person who appointed him without being in breach of a fiduciary
duty to the company on whose boards he sits. If this is correct, then the decision effectively denies shareholders in
the parent company a right of complaint. The argument that a shareholder cannot sue a nominee director may not
be attainable given the wide meaning attached to a director by s 65 of the Corporations Act and, the widespread
adoption of related party provisions and the group of companies as a model of business organization.

\textsuperscript{169} ASIC is further empowered under s 1324 to apply to the court for orders restraining the company from
undertaking certain transactions considered detrimental and oppressive to certain class of shareholders under ss
232 & 233.
Chapter 8  Shareholder Protection (Oppression Remedy Provision) 435

Where a member alleges that the conduct of the affairs of the company are oppressive it can seek an order or under both ss 232 and 1324 so that the affairs of the company can be regulated in the future, including an order that existing directors cease to hold office.¹⁷⁰

8.3.3.2. Share Capital Transactions & Conduct which may Trigger Oppression

'Selective dividends',¹⁷¹ selective buy-backs,¹⁷² selective reduction of capital,¹⁷³ and financial assistance,¹⁷⁴ may trigger oppression especially, where minority shareholders are eliminated by the cancellation of their shares.¹⁷⁵ While the rules of each transaction may differ, the legislation seeks to ensure that share capital transactions are fair and reasonable to the company’s shareholders as a whole and, do not materially prejudice the interests of the company or its shareholders.¹⁷⁶ There are various types of conduct which may also trigger the oppression remedy provisions.¹⁷⁷ A selective buy-back under s 257D which does not contain the minimum statutory pre-conditions and the disclosure information mandated by ASIC, ASX Listing Rules and ASIC Practice Statement 110 regarding to the proposed purchased price, may require a shareholder to evoke s 1324 to restrain the buy-back. Also a selective buy-back that would not allow preference shareholders to exercise their voting rights can be deemed a variation of their rights and oppressive conduct.

Similar situations would apply under s 260A (1) (a) where financial assistance would materially prejudice the interest of the company or its members. Also, under s 254T,

¹⁷⁰ See, Corporations Act 2001, s 233(1) (a-j) for the various orders the court can make. Generally, when s 232 is invoked, the plaintiff usually the minority shareholder is not alleging he or she was wronged by a director or controlling shareholder acting in his or her personal capacity. He is asserting that the corporation through the actions of its directors and controlling shareholders acted oppressively and that in the circumstances it is appropriate to rectify that conduct.

¹⁷¹ Corporations Act 2001 (Cth), s 254T.

¹⁷² Ibid, s 257D (1).

¹⁷³ Ibid, s 256B (2) (c).

¹⁷⁴ Ibid, s 260.

¹⁷⁵ Other transactions include a successful takeover under s 701 which facilitates the compulsory acquisition under s 667 of minority holdings of shares. Also, s 414 provides a counterpart procedure to s 701 where a scheme or contract involving a transfer of shares may result in the elimination and possible oppression.

¹⁷⁶ Corporations Act 2001 (Cth), ss 256A (b) & 256B (1b); ss 260A (1) (a) (i).

¹⁷⁷ The various conducts considered oppressive, unfairly prejudicial and unfairly discriminatory include: improper exclusion from participation in management; improper diversion of business; payment of excessive remuneration to a company controller; failure to prosecute an action; abuse of power by the directors—such as improper issue of shares; unfairly restricting dividends; making a share issue with the dominant purpose of reducing a shareholder’s proportional stake in the company; denial of access to information; unlawful divestiture of shares; oppressive conduct of board meetings. For a detailed overview of the various conducts, see, Ford et al, above n 3, para 11.460 at 609.
where a shareholder has not been paid dividends as required by the company’s constitution or, directors declared a dividend but never made payments but rather siphoned the dividends to their personal businesses, there is a possible clash of interests. Shareholders, as a group or as individuals may apply for an injunction to restrain the payment of an unlawful dividend under s 1324.\textsuperscript{178} According to Re Spargos Mining NL,\textsuperscript{179} a person who is a member at the time of the application may apply under s 234(a). The decision also provides that the statute liberally conferred standing so that an applicant can bring proceedings in respect of conduct that occurred before him (she) became a member. A former member may also bring proceedings in two circumstances.

First, if she/she has been removed from the register of members because of a selective reduction of capital\textsuperscript{180} or, if the person has ceased to be a member of the company and the application relates to the circumstances in which they ceased to be a member. Similarly, in Acehill Investments Pty Ltd v Incitec Ltd (No 2),\textsuperscript{181} the plaintiff Acehill was a substantial minority shareholder in Incitec Ltd. He sort relief under s 232 claiming that the affairs of the company were being conducted by the board of directors in a manner which was contrary to the interests of the members of Incitec as a whole. He alleged that the conduct of the affairs of the company were oppressive to, unfairly prejudicial to, or unfairly discriminatory against him (Acehill). He therefore sought orders pursuant to s 232. The oppression resulted from a proposed restructure of Incitec involving a reduction of capital under s 256B and a scheme of arrangement (s 411); a proposed acquisition by

\textsuperscript{178} Section 1324 gives standing to an oppressed minority to evoke the section and the court will give an injunctive relief in s 1324 (1B) challenging the fairness and reasonableness of the transaction. Also, ASIC may make an application under s 657A (1-2) that a proposed reduction for example, constitutes unacceptable circumstances.

\textsuperscript{179} (1990) 3 ACSR 1. Section 234(a) provides that an application for relief may be made by a person whom ASIC thinks appropriate having regard to investigations it has conducted into the company’s affairs or matters. Therefore, ASIC may authorize some one than itself to bring application for relief under Pt 2F.1. Under s 1330(1), ASIC may also intervene in proceedings by the other person (see, Jenkins v Enterprise Gold Mind NL (1992) 6 ACSR 539.

\textsuperscript{180} Corporation Act 2001, s 234(b). In Re Polyresins Pty Ltd 91998) 28 ACSR 671, Chesterman J of the Supreme Court of Queensland held that it was not possible for a controlling or majority shareholder in a company to be an applicant because the majority or controlling shareholder can act to eliminate the oppression. But Cf, Watson v James [1999] NSWSC 600 where Berris J of the NSW Supreme Court refused to follow Re Polyresins. Canadian Courts have allowed a majority shareholder in certain circumstances to bring an oppression action under s 241 of the “CBCA”. (See, Rice, (1989) 16 Can Bus LJ 58). Since it has previously been said that the oppression remedy provision for purpose of this study will concern ‘minority shareholder’, it is not reasonable for majority shareholders to evoke s 232 because the majority shareholders have a remedy in the general meeting and because, most of the oppressive cases are against the majority and other controlling shareholders and directors.

\textsuperscript{181} [2002] SASC 406.
means of a selective cancellation of shares of all shareholders other than those of one controlling shareholder in exchange for cash (commonly known as ‘buy-out’) and, that five of the board of seven directors on Incitec have a conflict of interest and duty. His submission generally was that the restructuring of the business was not in the interest of the company as a whole on the argument that the business had been substantially undervalued so that the cash consideration for the acquisition of the shares was too low. The court (Hansen J) held that the plaintiff had made his case of oppression against the company and its directors.

8.3.3.3. Some Advantages of the Oppression Remedy Provisions

8.3.3.3.1. Protects Existing and Former Shareholders.

In O’Neill v Phillips, Lord Hoffmann explained the role of the oppression provision to the effect that it protects past and present shareholders against the breach of terms on which they have agreed the affairs of the company should be conducted, through the articles of association or, some collateral agreement. Secondly, the provision protects shareholders against some inequity that makes it unfair for those conducting the affairs of the company to rely upon their strict legal power.\(^{182}\)

8.3.3.3.2. Equality in Treatment

The courts have used various means to test the fairness and reasonableness of a transaction or conduct that may be considered oppressive. The general view is that of fairness.\(^{183}\) However, that test of fairness carries various degrees of shapes. In a commercial atmosphere, the test is one of commercial fairness judged objectively. In Re Saul D Harrison & Sons plc\(^{184}\), a decision concerning the English equivalent of Pt 2F.1, the Court of Appeal emphasized that fairness is to be assessed in the context of

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\(^{182}\) Support for the proposition that oppression remedy provisions protect both current and past shareholders is well illustrated in the NZ case of, Philip Arthur Verry v Julia Anne & Ors [2003] NZCA 74. It is noteworthy that under both s 232 9Aust) and 459(UK), the oppression provision can only be made by current members of the company. These sections provide that “A member of a company” may apply. They omit any reference to former members. (Cf s 234 (b-c) which by implication, meant that even past members of the company are protection by the s 232 legislation. Though from a takeover situation there is the risk of increased litigation if former shareholders were permitted to sue, however, the s 232 must be rationalized for purposes of other share capital transactions if former shareholders are allowed to made applications where they have been unfairly prejudiced.

\(^{183}\) It would be important to take note also of the various criteria of fairness elucidated by the courts for purposes of the share capital reduction and other areas of the corporation’s law where fairness is used. To this effect, the standard of fairness applied in Chapter Three of this study must also to look into.

commercial relationships. In a non-commercial company, the test of fairness is considered from a view hypothetical view point of a reasonable person associated with the type of company in question. Here, the content of fairness will depend upon the context.

In O’Neill & Anor v Phillips & Ors\(^{185}\) the issue in question was whether the price paid for the shares of an exiting shareholder was fair and reasonable within the equivalent s 459 of the English legislation. The appeal raised a question on the scope of the remedy which the English Company’s Act\(^{186}\) provides for a member of a company, typically holding a minority of the shares, who alleges that the company’s affairs are being conducted in a manner unfairly prejudicial to his interests. In a unanimous opinion, delivered by the House of Lords, (Lord Hoffmann) reiterated that:

Fairness is the criterion by which the court decides if it has jurisdiction to grant relief. The concept of fairness also gave the court a wide power to do what appeared just and equitable but, he added, it had to be applied judicially and rationally.\(^{187}\)

His Lordship continued:

But the unfairness does not lie in the exclusion of the minority shareholder from continuing a working association with the company alone, but in exclusion without a reasonable offer. If the respondent to a petition has plainly made a reasonable offer, then the exclusion as such will not be unfairly prejudicial and he will be entitled to have the petition struck out. It is therefore very important that participants in such companies should be able to know what counts as a reasonable offer. In the first place, the offer must be to purchase the shares at a fair value. This will ordinarily be a value representing an equivalent proportion of the total issued share capital, that is, without a discount for its being a minority holding...If value for the purposes of buying out a minority shareholder were not agreed it should be determined by a competent expert, acting as such, with both parties having the same full right of access to information about the company bearing on the value and the right to make submissions to the valuer.\(^{188}\)

\(^{185}\) [1999] 1 WLR 1092.

\(^{186}\) Part XVIII, Companies Act 1985, ss 459-461.

\(^{187}\) [1999] 1 WLR 1092 at 1098. Lord Hoffmann further said that in considering the equitable principles to apply, one useful cross-check is to ask whether the exercise of the power in question would be contrary to what the parties, by words or conduct, have actually agreed (at 1101). It is noteworthy that where the exercise of power involves discrimination between the classes of shareholders, the common laws courts regarded this as unfair: Mills \textit{v} Mills 919938) 60 CLR 150, at 164 per Latham J.

\(^{188}\) Ibid at 1107C-F. Similarly, in Australia, the courts held in Dynasty \textit{v} Coombes (1995) 138 ALR 64 at 86-87 that it was not a fair practice to apply a minority discount to a share value. The full court held that while there was discretion to discount, in order to come to a fair value there was also an inclination against doing so. The court
8.3.3.3. Winding-up Remedy

Winding up under s 233, based on the 'just & equitable' remedy principle\(^\text{189}\) is one of the favored remedies applicable in most common law jurisdiction for purposes of oppressive conduct.\(^\text{190}\) If an order is made under s 233 the provision relating to winding-up of companies applies as if it was under s 461. In *Kokotovich Constructions Pty Ltd v Wallington*\(^\text{191}\), the court was prepared to appoint a liquidator for the winding-up of a solvent company because of the continuing animosity existing between the two shareholders, the risk of further oppression and the very limited nature of the company's activities. When a winding-up is granted some shareholders may leave the company, selling their shares to others who continue to run the business. Others may buy the business from the liquidator and continue to run it.\(^\text{192}\) A minority shareholder who may have been materially prejudiced under any of the transactions affecting share capital may gain to the extent that, any compulsory acquisition resulting in his/her elimination from the company entails the shareholder to be bought-out at a higher or, reasonable fair value for its shares.

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\(^{189}\) The weight of judicial opinion is against a 'minority discount'. (See, *Re Bird Precision Bellows Ltd* [1984] Ch 419. was applied by *Properties Ltd* (1987) 38.

\(^{190}\) When an application is made under s 233 and the court is satisfied that the company is insolvent the company may order that the company be wound-up in insolvent under s 459B. This is also true of breaches of sections 123 & 214 of the English *Insolvency Act* of 1966. *Re Westborne Galleries Ltd 1973* AC 360 provides a good illustration of how the just and equitable remedy of winding up the company could satisfy some of the legitimate expectation of the minority. See also, *Ex Parte Shooter* [1990] BCLC 384. (See also, *Re Dalkeith Investments Pty Ltd* (1985) 3 ALC 107 at 181, where McPherson J noted that the wind-up a viable company would be prejudicial to the other shareholders in the company but, that a buy-out at the direction of the court would satisfactorily resolve the matter. A similar position was also upheld by Oliver LJ in *Re Birb Precision Bellows Ltd* [1986] 1 Ch 658 under an analogous UK position. Generally, winding-up is appropriate where it is shown that relevant prejudice will occur if a company is allowed to carry on under its existing controllers as is the case where a company is insolvent and continuation will prejudice the interests of creditors and shareholders (see, *CIC Insurance Ltd v Hannan Pty Ltd* (2001) 38 ACSR 245).

\(^{191}\) Under the earliest legislation, the courts power to order a winding-up was qualified so that it could not make an order if it was of the opinion that the winding-up would unfairly prejudice the oppressed member(s). (Former s 246AA (4)). This is no longer the case.

\(^{192}\) *Re A Company: Ex Parte Estate Acquisition & Development Ltd* [1991] BCLC 154 at 161. One defect with the winding-up remedy is that after a company has been wound-up and creditors paid what was due to them, there may be nothing left to pay to minority shareholders as compensation. Also, the courts have been reluctant to wind-up a solvent and prosperous company simply because certain members have been oppressed. This situation was enunciated by the Privy Council in *Cumberland Holdings Ltd v Washington H. Soul Pattison & Co Ltd* (1977) 2 ALCR 307 in the following statement:

Indeed, the statutory provisions are widely expressed and effect should be given to them in accordance with their terms whenever the court comes to the conclusion that there has been a lack of fairness, or oppression, or lack of probity on the part of the majority, or of the directors representing the majority. But to wind-up a successful and prosperous company and one which is properly managed must clearly be an extreme step and must require a strong case to be made.
In the Canadian case of Budd v Gentra Inc, directors and controlling shareholders were sued by a minority shareholder for compensation because the company’s financial resources were given out in the form of loan and other payments considered prejudicial to the interest of some minority members. The court (Farley J), invoking s 214 of the CBCA held in favour of the minority shareholder for a payment of a fair value relating to the loss individually suffered by the plaintiff. In Scottish Co-operative Wholesale Society Ltd v Mayer, Lord Denning reiterated that:

...To order the oppressor to buy the shares of the oppressed at a fair price, would mean that a fair price would be, I think, the value which the shares would have had at the date of the petition, if there had been no oppression ... It is, no doubt, true that an order of this kind gives to the oppressed shareholders what is in effect money compensation for the injury done to them.
8.4. **Conclusion: Whither the Maintenance of Capital Doctrine?**

The capital maintenance rules dealt with in this study remained deeply entrenched in corporate finance law for more than a century. Though the rules are by no means detailed and complex, it is probably fair to say that they have not been adequately subjected to any systematic review. A comprehensive review of the doctrine in the various chapters making up this study, suggests that it is an opportunity to examine the future of the rules as a regulatory structure.¹⁹⁵ In doing this it is important to ask certain questions:

- Does the system appear to have a rational set of objectives?
- If so does it pursue those objectives in a logical fashion?

The 19th Century capital maintenance doctrine has been significantly ameliorated in a number of respects but the present system continues to provide haphazard objectives lacking in clarity and focus. The various chapters of this study have highlighted complexities of a number of areas of the existing rules where the law is either unclear or somewhat problematic. It is worth observing that it is far from easy to discern any clear set of objectives behind the various rules dealing with share capital. In a fashion typical of the English development they have grown up in a piecemeal fashion, often in response to particular perceived problems. The basic principles of capital maintenance, from which all the rules in this area may be considered to have been derived, may be regarded as still retaining some validity in the sense that since its inception some 146 years ago, it is legitimate to suggest that creditors want some degree of assurance of the financial solidity of the company with which they deal. On the other hand, the deficiencies of the theory have already been alluded to.¹⁹⁶

The principles underlying the doctrine of capital maintenance based on a corporation’s share capital were discussed in Chapter 1. The general analysis in that chapter and subsequent chapters reveal difficulties of making a legal assessment of the value of share capital and its maintenance. The study demonstrates that the rules on share capital appear

¹⁹⁵ Generally, the capital maintenance doctrine and limited liability continue to have a number of important attributes and notwithstanding changes to it, the basic underlying assumption nevertheless remains intact (i.e., share capital should not be dissipated unnecessarily and creditors need to be protected). The operation of the doctrine however gives rise to consequences that cause concern and merit some special legal and economic treatment.

¹⁹⁶ See Chapter One where the justification and deficiencies of the doctrine were evaluated.
to be irrelevant for a significant majority of Anglo-Australian companies. It was also demonstrated that creditors do not rely on share capital either, for their protection or security of their claims but on the company’s cash flow and overall net assets. This is evident in the fact that in recent year’s company law has departed from the strict doctrine by allowing the removal of a company’s capital in some circumstances. Under the Corporations Act 2001, companies are allowed to buy-back their shares (s 257D); reduce share capital (s 256B) and provide financial assistance for the purchase of their own shares (s 260A) not in strict compliance with maintenance of capital requirements but in accordance with solvency requirements and liability provisions.

Traditionally, it may be said that the idea of a minimum capitalization requirement was part of the price paid for limited liability, but this trade off as suggested in chapter six, appears largely obsolete in an environment where limited liability has come to be seen as a right rather than a privilege. As a consequence, the minimum paid-up capital provides an illusory protection to creditors. The study suggest that the European Union abandon its minimum capitalization requirement in favour of a statutory guarantee fund which as illustrated in Chapter 6, will effectively protect creditors who are unable to contract around limited liability.

It is also fairly obvious that the present rules allow for significant derogations from the capital maintenance principle, not least in relation to share buy-backs, financial assistance for the purchase of shares and reduction of capital. It is suggested that while Australia retains its current buy-back and reduction of capital regimes, the lack of an express financial criterion would suggest that the solvency test be clearly indicated as a prerequisite for allowing companies to buy-back their own shares or reduce their share capital. It would be more appropriate also if the law provides clarifying legislation with regards to the s 257D (1) (a) and (b) and s 256C (2) (a-b) shareholder approval provisions based on the proposals suggested under those chapters. A secondary consideration taken into account in deciding on a selective reduction of capital and selective share buy-back is the possible prejudice to shareholders. This will have to mean shareholders other than those whose shares are to be selectively bought-back or reduced, and other than any who
voted in favour of the resolution to authorize the transactions. Although the use of class rights within companies is not as common as it was, the analysis of the different uses to which share capital can be put suggest that it would be beneficial if class rights could be used more frequently in order to distinguish these uses. This suggests a reform and clarification of the rules for creating and amending class rights. The present rules are unnecessarily complex in procedural terms, whilst at the same time undesirably vague from the point of view of identifying exactly what rights are protected and in what circumstances these rights can be altered. These rules predate the current oppressive remedy provisions in ss 232-234 and it may be suggested that any amendment should take account of this by applying the s 232 test to any objection to vary or abrogate class rights.

The history of rules on financial assistance for the purchase of a company's shares is not a happy one. Though the rules have been relaxed, compliance with the procedural safeguards illustrates a very technical character. Case law to that effect suggests that the rules continue to constitute a trap for the unwary. However, while the current rule is a significant improvement, certain amendments are warranted for the s 260 legislation. The s 260A (1) material prejudice test needs clarifying language that makes it consistent with a similarly worded s 256B (1)(b) and s 232(d). There are inconsistencies and overlaps as to how financial assistance is addressed by director's duties, insolvent trading provisions and related party provisions. While the current regime be retained, regulation of financial assistance by a dual solvency test and insolvent trading provisions would remove much duplication of regulation.

The regulation of dividends on distributable profits is unsatisfactory and has remained problematic and does not seem to adequately provide protection to creditors. The current law needs an extensive amendment to accommodate the solvency requirement and international accounting standards so that companies would be allowed to pay dividends as long as the balance sheet and cash flow solvency tests were maintained. Moreover, the remedies for recovering unlawful dividends under the current law are unclear. The more streamlined set of remedies suggested in the discussion of dividends must be taken into
account when reviewing the current law. The rules on the issue of new shares may probably be considered unnecessarily technical in many respects. The discussion in the previous chapter has highlighted the extent to which the rules pose technical obstacles which are at best disproportionate to the objectives being pursued and at worst irrelevant to those objectives.

In accordance with the above, it is suggested that the objectives of the capital maintenance doctrine can be recast. Arguably, such a recasting would be more than a belated recognition of the premises underlying the rules which now exist. Such objectives might be presented under the following considerations:

- To protect creditors from the unreasonable diminution of the value of the company’s assets against which they would be able to enforce their claims without accepting a formal equivalence between issued share capital and asset values.¹⁹⁷

Clearly, creditors have a legitimate interest in the continuing financial viability of the company. This is reflected in the solvency requirement which requires a company to be viable in both its cash flow and balance sheet sense and the insolvent trading rule which requires a company to be able to pay its debts as they become due.¹⁹⁸ These are areas where the major forms of protective legislation do not directly relate to the maintenance of share capital. Directors are exposed to potential civil and criminal liability for insolvent trading and also to disqualification if the company subsequently becomes insolvent.¹⁹⁹ Although the depletion of the company’s capital is something which could properly be taken into account in any of these proceedings, it is neither a necessary nor a sufficient condition for the imposition of liability.

- To protect existing and even future shareholders from forced depletion of their assets in the company, either by the dilution of that interest or by its devaluation.

¹⁹⁷ This point of view is consistent to that of, A. McGee, Share Capital (London: Butterworth’s, 1999) at 138.
¹⁹⁸ See, subpart 8.2 above, for a detailed analysis of solvency requirement, and 8.3.1 above in relation to insolvent trading provisions.
This is an objective clearly recognized by the existing rules requiring directors to be authorized before issuing share capital, and by those rules which provide pre-emption rights for existing shareholders on the issue of new capital. Aside from these measures, Anglo-Australian Law had developed more general notions of the protection of shareholders by way of oppressive conduct of the majority. Finally, there must be the need to protect the company as an entity from being looted by unscrupulous shareholders and promoters. Rules of share capital can play only a relatively small part in achieving this.

The history of company law has numerous examples of directors who paid out company's capital in the form of dividends in order to maintain themselves in position or to please the majority shareholders to maintain them in power.\textsuperscript{200} However, the various insolvency rules which restrain the ability of directors and controlling shareholders made such actions more difficult in the present day economy. The asset maintenance (solvency based) model developed in this study enables the evaluation of a range of possible creditor–shareholder protection options. They are an improvement to the capital maintenance doctrine and will need to be extensively integrated into recent and future regulatory measures in Anglo-Australian corporate financial transactions.

A shift from the maintenance of share capital to that of solvency and asset requirements as envisaged in this study does not suggest an abolition of the maintenance of share capital doctrine. Though originally reflected in a number of more specific legal rules, it remains a doctrine of wide application capable of applying outside the more particular rules which it has generated.

\footnote{Kostal, R.W; \textit{Law and English Railway Capitalism 1825 -1875} (1995).}
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