

CORPORATIONS LAW SIMPLIFICATION PROGRAM

SHARE CAPITAL RULES
PROPOSAL FOR SIMPLIFICATION

TASK FORCE
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Simplification Task Force
Attorney-General's Department
Barton ACT 2600

Share capital rules Proposal for simplification

The share capital of a company is the sum of the contributions made by shareholders to the company in return for the issue of shares.

This proposal suggests a number of changes to the share capital rules in Part 2.4 of the Corporations Law. A brief outline of how the proposal developed from the existing share capital rules is at pages 8-10.

The proposal

The proposal addresses current problems and confronts the issues of real concern to shareholders, creditors and investors. For the protection of shareholders and creditors it establishes solvency as the basic test for determining whether a company should enter into a transaction and so moves many of the rules on share capital towards greater uniformity with the rules in other areas of the Law. It also adds extra measures to secure fairness among shareholders.

Under the proposal:

- shares will no longer have a par value
- shareholder and creditor protection will focus on company solvency
- capital reductions will not require authorisation by the articles or court confirmation
- equal access capital reductions will not require shareholder approval
- selective capital reductions will require shareholder approval (this rule is not intended to alter the operation of the rules on class rights)
- the rules on financial assistance will be streamlined
- the rules against self ownership will be replaced by rules that turn on actual control over the votes attaching to the company's shares.

Current approach

The proposal tackles the problems in the existing rules.

Form rather than substance

The existing rules concentrate on the legal formalities of transactions, rather than on their commercial impact. For example, the current capital maintenance rules focus on the transfer of money to and from particular accounts, rather than on whether the company will actually be able to pay its debts when they are due. But they do not adequately protect shareholders and creditors because a company might:

- have paid up capital of as little as \$2
- dissipate its capital in trading losses or through poor investments
- charge its capital, leaving virtually nothing for unsecured creditors.

The real concern of creditors and shareholders is the company's continuing solvency.

Complicated and confusing

Many of the rules are complicated. For example, the prohibition on providing financial assistance (section 205) is followed by 7 pages of detailed and sometimes difficult definitions and exceptions.

The complications in the rules add to transaction costs and can prevent companies moving quickly enough to exploit commercial opportunities.

A large number of complicated rules are needed to deal with the notion of par value (for example, the prohibition on issuing shares at a discount, the requirement for a company to have a share premium account and the restriction on distributions from that account).

Confusion arises out of there being a difference between the par value of a share, its market value and its net asset backing.

Costly

The rules result in unnecessarily high compliance costs. For example, a capital reduction requires shareholder approval and court approval, even if no shareholder or creditor objects to the reduction.

Overseas changes

Canada (1974) and New Zealand (1994) have made far-reaching changes to their share capital rules. Both countries have abandoned the capital maintenance doctrine and placed greater emphasis on company solvency. The Task Force proposal adopts this approach.

No par value shares are compulsory in New Zealand, Canada, and some states of the US. In South Africa and some other states of the US, companies may choose whether their shares will have a par value.

Shareholder approval is required for all capital reductions in Canada. In New Zealand directors may approve some transactions that reduce capital; others allow an option of director approval or unanimous shareholder assent; and still others allow director approval, with scope for shareholders to apply to court, opposing the transaction. The Task Force proposes that only selective capital reductions will require shareholder approval. For selective capital reductions those whose shares are being cancelled will be able to apply to the court opposing the reduction.

Share buy-back reforms

In developing the share buy-back proposal, the Task Force concentrated on the 3 themes of solvency, fairness among shareholders and disclosure of all information material to the shareholders' decision. The proposed share capital rules continue this emphasis, and accommodate the fact that buy-backs are voluntary transactions, while capital reductions may involve the compulsory cancellation of a share.

No liability companies

The introduction of no par value shares will not affect the current rules relating to no liability companies or the ability of limited companies to issue partly paid shares.

Taxation

The Task Force has commenced discussions with the Commonwealth Treasury and the Australian Taxation Office with a view to identifying consequential amendments that would be required to the *Income Tax Assessment Act 1936*.

The Task Force recognises that the tax issues will need to be resolved before the new rules commence.

THE PROPOSAL

Proposal	Issues for consideration
<p>Repeal of current share capital rules</p> <p>1. Sections 185, 189, 190-193, 195, 201-206, 206AAA-206AAH and 216 of the Law will be repealed. The rules set out below will replace them.</p> <p>No par value shares</p> <p>2. After the commencement of the new rules all shares will be no par value shares.</p> <p>3. The Law will convert all existing shares to no par value shares. This conversion will not affect any right or obligation attaching to shares (including any obligation to pay calls) under any company's articles.</p> <p>4. The concept of authorised capital will no longer have any role under the Corporations Law.</p> <p>5. The share premium account and capital redemption reserve will be abolished. Any funds in these accounts will be transferred to the share capital account. All funds received upon an allotment of shares will be credited to the share capital account.</p> <p>6. References in the Corporations Law to nominal value will be changed to references to number of shares.</p> <p>Dividends</p> <p>7. A company will be able to pay dividends out of profits, as at present. If a company pays dividends out of capital, it must follow the procedures in paragraphs 9-13.</p>	<p>a) Does this conversion have implications for references to par value in existing contracts which should be dealt with in the Law?</p> <p>b) Should the commencement of the new rules be delayed to permit companies to make any necessary amendments to their articles?</p> <p>What transitional provisions should be provided? For example, should companies that already have redeemable preference shares on issue be required to retain a share premium account until the shares are redeemed?</p>

Proposal	Issues for consideration
<p>Reductions of share capital</p> <p>8. A company may reduce its share capital if it follows the procedures in paragraphs 9-13.</p> <p>Exceptions concerning the granting of a right to occupy or use land or buildings (sections 195(13) and (14)) and capital reductions resulting from the application of Chapter 6 (section 195(15)) will be continued.</p> <p>9. A company must give the ASC 14 days notice of a proposed capital reduction.</p> <p>10. If a capital reduction involves the cancellation of a share, the company must give the holder of the share 14 days notice of the proposed cancellation.</p> <p>11. Any shareholder whose shares are to be cancelled under a selective capital reduction may apply to the court for an order opposing the capital reduction on the grounds that the terms of the reduction are not fair and reasonable.</p> <p>12. The company's shareholders must approve a selective capital reduction by either:</p> <ul style="list-style-type: none"> • a special resolution passed at a general meeting of the company (any shareholder to whom the capital is paid and their associates may vote against, but may not vote in favour of, the reduction), or • a resolution agreed to by all ordinary shareholders. <p>This rule will not alter the operation of the rules on class rights.</p>	<p>a) Should there be any limit on the size of capital reductions which can be made within any 12 months period? What should that limit be?</p> <p>b) Is it necessary to preserve the exceptions for brokerage and commission payments (section 204)?</p> <p>a) Are any additional protections necessary for minority shareholders whose shares might be cancelled against their wishes? For example, should the company bear the burden of showing that the terms of the reduction are fair and reasonable?</p> <p>b) Should any other shareholders be able to apply to court and in what circumstances?</p> <p>a) Given the present treatment of redeemable preference shares, should their redemption be governed by these rules or should it be excepted from the rules applying to capital reductions?</p> <p>b) Would it be more appropriate to exclude the instigator of the capital reduction and their associates from voting? How would the instigator be identified?</p>

Proposal	Issues for consideration
<p>13. 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 whether to vote in favour of the resolution.</p> <p>However, the company does not have to disclose information if it would be unreasonable because the company had already disclosed it.</p> <p>Financial assistance for dealings in a company's own shares</p> <p>14. A company may only assist a person financially to acquire its shares, or shares in a holding company of the company, without shareholder approval if the financial assistance:</p> <p>(a) is given on arm's length terms in the ordinary course of commercial dealing, or</p> <p>(b) relates to the acquisition of an equitable interest in shares, where no consideration is paid by the company or a related corporation, or</p> <p>(c) is given under a court order.</p> <p>15. However, financial assistance can be given if it is approved by a special resolution of:</p> <p>(a) the company's shareholders; and</p> <p>(b) if the company is a subsidiary:</p> <p>(i) any holding company of the company that is listed on a stock exchange, or</p> <p>(ii) if there is no listed holding company, any ultimate holding company of the company that is incorporated in Australia or an external territory.</p>	<p>a) Should this prohibition be limited to situations involving a change of control? Should the rule be abolished altogether?</p> <p>b) Should the legislation attempt to define the concept of giving 'financial assistance'?</p> <p>c) If the prohibition is to be retained, should the prohibition on lending money on the security of the company's own shares (section 205(1)(c)) be retained?</p> <p>Should there be any voting exclusions? For example, should the person acquiring the shares and their associates be excluded from voting?</p>

<p style="text-align: center;">Proposal</p>	<p style="text-align: center;">Issues for consideration</p>
<p>16. 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 whether to vote in favour of the resolution.</p> <p>However, the company does not have to disclose information if it would be unreasonable because the company had already disclosed it.</p> <p>17. A company must give the ASC 14 days notice before giving financial assistance.</p> <p>Insolvency</p> <p>18. A company's directors will be personally liable if the company would be insolvent immediately after:</p> <ul style="list-style-type: none"> • the declaration of a dividend, or • a reduction of capital, or • the giving of financial assistance. <p>The liability will be based on the current insolvent trading rules and the similar rules proposed in relation to share buy-backs.</p> <p>19. A shareholder or creditor of the company will be able to seek an injunction if the company would be insolvent immediately after:</p> <ul style="list-style-type: none"> • the declaration of a dividend, or • a reduction of capital, or • the giving of financial assistance. <p>Rules against companies controlling their own shares</p> <p>20. A company may not directly acquire its shares unless it follows the procedures laid down in the new share buy-back provisions.</p>	<p>Should this be required in the circumstances referred to in paragraph 14? If not, should paragraphs 18 and 19 apply to those circumstances?</p>

Proposal	Issues for consideration
<p>21. An entity that is controlled by a company must not acquire a relevant interest in a share in the controlling company.</p> <p>22. If a company acquires control of an entity that has a relevant interest in a share in that company, then within 12 months, the company must either:</p> <ul style="list-style-type: none"> • cause the controlled entity to dispose of its relevant interest in a share in the controlling company, or • end its control of the controlled entity. <p>During this period, the voting rights attaching to the shares in the controlling company cannot be exercised.</p> <p>23. If a company acquires a relevant interest in 10% or more of its voting shares, the ASC may refer the acquisition to the Corporations and Securities Panel for a declaration that the acquisition is unacceptable, having regard to its effect on potential takeovers of the company.</p> <p>This rule will not apply in the case of an acquisition arising from a buy-back.</p>	<p>a) Should this rule be confined to voting shares?</p> <p>b) Should 'control' be defined? If so, how? Should any definition of control turn on particular levels of shareholding or on more general measures of control? Should potential to control be included?</p> <p>c) Should this rule be confined to bodies corporate, as at present, rather than extend to other entities?</p> <p>d) Does using the 'relevant interest' test, rather than the 'membership' test in section 185, make this rule too broad?</p> <p>e) Would it be better to focus on the company's ability to control the exercise of rights attaching to its own shares, however this ability arises?</p> <p>a) Should the controlled entity also be required to dispose of its relevant interest in a share in the controlling company?</p> <p>b) Should the Court or the ASC be able to extend the 12 months period? In what circumstances?</p> <p>c) Should the ASC be able to grant exemptions from the prohibition against voting? In what circumstances?</p>

Proposal	Issues for consideration
<p>Other changes</p> <p><i>Redeemable preference shares</i></p> <p>24. The share buy-back provisions will be extended to allow the buy-back of redeemable preference shares.</p> <p><i>Options</i></p> <p>25. As at present, the maximum period within which options created by public companies over their unissued shares can be exercised will be 5 years.</p> <p><i>Share warrants</i></p> <p>26. Companies will be prohibited from issuing share warrants, as at present.</p> <p><i>Stock</i></p> <p>27. The concept of stock will be abolished.</p>	<p>a) Should there be any maximum time period? If so, what should the maximum period be?</p> <p>b) Should this rule be confined to listed companies?</p> <p>Would a delayed commencement be necessary to allow holders of stock to convert it to shares?</p>

The Task Force is releasing this proposal as part of its process of consulting the community widely and involving interested groups in the Simplification Program.

You are invited to send comments on any aspect of the proposal to the Task Force by:

Friday 17 February 1995

DEVELOPMENT OF THE PROPOSAL

Current law

The existing share capital rules in Part 2.4 are based on company law theory and practice developed in the mid 19th century. They are designed to protect creditors and shareholders by imposing restrictions on distributions of a above company's capital.

Some of the rules are concerned with preserving the share capital funds credited to particular accounts.

The main rules specify that:

- capital may only be reduced if authorised by the articles, with shareholder approval and court confirmation, and with the opportunity for creditors to object (section 195)
- companies may only issue and redeem redeemable preference shares on terms contained in the company's constitution and any premium payable on the redemption must be paid out of profits or the share premium account (sections 192 and 200)
- companies may only finance dealings in their shares with shareholder approval, subject to court challenge by shareholders or creditors on the grounds that the assistance threatens the company's financial position (section 205)
- companies may pay interest out of capital in some circumstances, with court approval (section 202)
- companies may pay commissions or brokerage fees only up to a certain amount on subscriptions for shares, if not prohibited by the company's constitution, and if the payment is disclosed (sections 203 and 204)
- the directors may be personally liable for transactions undertaken contrary to these rules (sections 201, 203, 205, 206, 206AAG and 232).

The par value rules seek to ensure that a minimum amount is contributed to share capital for each share issued.

The main par value rules are:

- companies may only issue shares at a discount to par value with shareholder approval and court confirmation (section 190)
- companies that issue shares at a price par value (ie at a 'premium') must generally treat that premium as if it were share capital (section 191).

The Law currently imposes very few restrictions on the payment of dividends. The only significant rule is that dividends may only be paid out of profits, or by the issue of shares out of share premiums (section 201).

The rules prohibit companies from financing dealings in their own shares (sections 205 and 206).

The principal rules directed at control issues seek to ensure that share capital transactions do not inappropriately affect control of the company. They:

- prohibit subsidiaries being members of their holding companies (section 185)

- give the ASC power to declare situations where companies hold a relevant interest in creditors on the grounds that the assistance more than 10% of their voting shares to be unacceptable (sections 206AAA-206AAH).

Principles underlying the Task Force's review

In developing the proposal, the Task Force started with the 3 themes which it had pursued in developing the share buy-backs proposal:

- solvency
- fairness among shareholders
- disclosure of all material information.

At the same time, the Task Force took into account factors which had not been relevant in the context of share buy-backs, but which are important in the context of a more general review of the share capital provisions:

- capital reductions might involve the compulsory cancellation of a share, while share buy-backs are by their nature voluntary transactions
- there are well established commercial practices which operate in the broader arena (eg payment of interim dividends without the need for shareholder approval) which should not be unduly disrupted in the inflexible pursuit of general themes.

Solvency

The proposal seeks to ensure that a company will not be rendered insolvent through the payment to its members of dividends, reductions of capital or the giving of financial assistance in connection with the acquisition of its shares. As with the draft share buy-backs provisions, this proposal envisages the following safeguards against transactions which lead to the company becoming insolvent:

- the company will be required to give the ASC notice of the transaction
- shareholders and creditors will have a right to an injunction where the company would be insolvent immediately after the transaction
- directors will be personally liable under the proposed extension of the insolvent trading provisions to dividends, reductions of capital and financial assistance
- shareholders not acting in good faith may be liable to compensate the company under the antecedent transactions provisions.

Fairness

The present share capital rules employ a number of different approaches to achieving fairness among shareholders:

- mandatory court approval (sections 190, 195 and 202)
- scope for court challenge (section 205) shareholder approval mechanisms, requiring different majorities:
 - ordinary resolution (sections 190 and 193)
 - special resolution (sections 195, 202 and 205)

- banning transactions unless authorised by the articles (sections 192, 193, 195, 200, 202 and 204).

The Task Force proposes to continue the focus of the existing share capital rules on fairness among shareholders. This would be consistent with the proposed simplification of the buyback provisions. However, because some capital reductions may be compulsory the proposal includes, in addition to shareholder approval, a remedy for dissatisfied shareholders whose shares are being cancelled without fair and reasonable treatment.

Disclosure

As with share buy-backs, the share capital proposal will require that shareholders who approve a reduction of capital or the giving of financial assistance be given all information known to the company that is material to their decision.

No par value shares

It seems to be generally acknowledged that the par value rules have no great continuing practical importance. Many groups have called for the abolition of the rules. In 1990, the Companies and Securities Law Review Committee recommended that no par value shares be allowed. The Committee saw this as providing an additional option to companies and contemplated a situation where companies might have some shares with a par value and other shares without a par value.

The Task Force agrees with the Committee that there is no reason in principle why no par value shares should not be allowed. However, to allow both par and no par value shares would make the Law more complex and might even result in more confusion for shareholders than presently occurs. The Task Force believes Australia should move to a completely no par value system, as New Zealand and Canada have done.

The Task Force recognises the need to provide adequate transitional arrangements for this change. Amendments to the Corporations Law and to taxation legislation would be necessary. This is one of the areas that is being discussed with the Commonwealth Treasury and Australian Taxation Office.

The Task Force also envisages that the process of public exposure and comment, first on the proposal and in due course on draft provisions, will provide companies with a sufficient opportunity to consider how the change might impact on them and to put in place arrangements to deal with any implications.

Dividends

Application of the themes mentioned above might suggest that:

- whichever source (profit or capital) is used to pay dividends should not be so important
- if dividends are selective they should be required to be approved by those shareholders who are not the beneficiaries.

As mentioned below, the proposal requires shareholder approval in respect of other selective transactions covered by the share capital provisions. However, it would be too disruptive to existing commercial practices to require this in the case of dividends paid

out of profits. Accordingly, in that area, the proposal continues to allow the current rules to apply.

The Task Force does, however, consider that directors should not be able to pay a dividend where the dividend would result in the company's insolvency. Accordingly, it is proposed that the rules on liability for insolvent transactions which were developed in the context of the buy-back proposal will apply to all transactions covered by the share capital provisions, including the payment of dividends.

Capital reductions

The rules on capital reductions in the Corporations Law are currently very prescriptive. Reductions are banned unless approved by the courts, and various procedures are involved W seeking court approval.

Consistent with the themes pursued W the buybacks proposal, the Task Force proposes the removal of mandatory court approval and creditor notice rules for capital reductions. Instead, shareholder approval will be required in cases where some shareholders may benefit at the expense of others. Disclosure obligations and court remedies will also be imposed to allow shareholders and creditors to intervene in a case where their interests might be unduly prejudiced.

Financial assistance for dealings in a company's own shares

The current rules are very complex. They have gradually developed from much simpler rules introduced in response to the UK Greene Committee's (1926) concern that a person should be prevented from acquiring a controlling interest in a company by using the company's own funds.

The rules are now so complex that their original purpose is obscured. They inhibit many ordinary commercial transactions or require exemption from the prohibition under a cumbersome shareholder approval procedure.

The proposal therefore streamlines the rules W light of the 3 themes above to reduce the cost of determining if the prohibition does apply or using the shareholder approval exemption procedure.

Control

In this area the proposal does not seek to amend the rules in any fundamental way. The main change concerns the tendency of the current rules to focus on particular legal structures and concepts, such as the concept of 'subsidiary' and the formal ownership of a share.

In the Task Force's view, prejudice can arise to shareholders whenever a company controls its own shares, whatever the particular legal form is that has led to that situation. In order to appropriately protect shareholders, the rules should address the commercial reality of control rather than legal technicalities.