PREM 19/1064

Companies Bill. Employees Interests and Insider Dealing.

INDUSTRIAL POLICY

October 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~25.10.79~~		~~16.5.83~~					
~~29.10.79~~		~~19.5.83~~					
~~6.5.80~~		26.5.83					
~~20.6.80~~							
~~30.5.80~~							
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~~12.2.81~~							
~~12.3.81~~							
~~24.9.81~~							
~~14.6.82~~							
28.6.82							
~~18.11.82~~							
~~16.3.83~~							
~~3.5.83~~							

PREM 19/1064

Dd 533270 5M 2/78 8362633 JET

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(81) 11th Meeting, item 1	12/03/1981
L(81) 48	17/02/1981
L(81) 20	23/01/1981

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed J. Gray Date 5/2/2013

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

The Purchase by a Company of its Own Shares, to be published by HMSO as Command 7944.
ISBN 0 10 179440 1

Signed J. Gray Date 5/2/2013

PREM Records Team

SC

CONFIDENTIAL

Ind. Pol.

KBPM

DEPARTMENT OF HEALTH & SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Joint Parliamentary Under Secretary of State

MG 2/6

The Rt Hon William Whitelaw CH MC DL
Secretary of State
Home Office
Queen Anne's Gate
London SW1

26 MAY 1983

Dear Mr Whitelaw,

COMPANIES ACTS AND PENSIONS SCHEMES ETC

I have seen Arthur Cockfield's Private Secretary's letter of 3 May to your Private Secretary and the related correspondence. I would wish on Norman Fowler's behalf to add this Department's support for early legislation to put matters right. We are extremely concerned that all transactions on behalf of pension schemes should be validated. The situation where the pension scheme is a subsidiary of the parent company is a fairly common one and it is accepted that Inland Revenue requirements lead to the parent company having a beneficial interest, at least in theory, on a contingency basis.

Copies of this letter go to Michael Scholar (No 10), members of H Committee, the Attorney General, the Lord Advocate, to First Parliamentary Counsel and to Sir Robert Armstrong.

Yours sincerely,

David Trefgarne.

LORD TREFGARNE

CONFIDENTIAL

Companies Bill ; [illegible] Oct 79

From: THE PRIVATE SECRETARY

WR 20/5

NORTHERN IRELAND OFFICE
GREAT GEORGE STREET,
LONDON SW1P 3AJ

John Rhodes Esq
PS/SOS Department of Trade
1 Victoria Street
London
SW1H 0ET

19th May 1983

Dear John,

COMPANY LAW AMENDMENT

Thank you for copying to me your letter of 3 May to Colin Walters about the need to remedy a defect in the law on trust funds.

Northern Ireland company law, which is identical to the GB legislation, also contains the serious technical problem which you describe. If legislation is required, we should need to amend both codes and it would be essential that amending provisions to the GB and the Northern Ireland legislation came into effect at exactly the same time. If this is not achieved the gap in these inter related statutes covering the UK as a whole might be able to be exploited in a damaging way.

At present officials from the Department of Economic Development in Northern Ireland are in contact with Department of Trade officials to establish the best means of achieving the necessary amendment to the NI legislation. If you agree, I suggest that contact continues at official level with a view to presenting Ministers with possible solutions immediately after the general election.

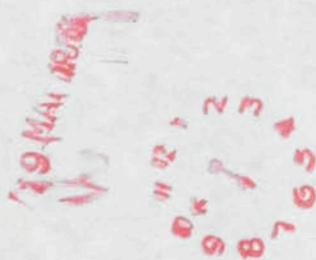
I am copying this letter to the recipients of your letter of the 3 May.

Yours ever,

John Lyon

J M LYON

Ind Pol 1
Oct '79
Companies Bill



Ind. Pol.

Prime Minister 2

MCS 17/5

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

16 May 1983

Dear Arthur,

Thank you for your letter of 26 April about new legislation to amend the Companies Acts in relation to pension funds etc. I have subsequently seen your Private Secretary's letter of 3 May to the Home Secretary's Private Secretary.

It seems to me clear that we will have to legislate on this matter as soon as possible and I hope that you will receive policy clearance from H Committee. As for the timing of the legislation, this will clearly have to wait for a decision until after the election, when the Cabinet will wish to examine the programme for the new Session. In the meantime I see no reason why preparations should not go ahead. On the understanding, therefore, that policy approval is forthcoming from H Committee, I authorise the employment of Parliamentary Counsel to draft legislation on a contingency basis.

I am copying this letter to the Prime Minister, the members of H Committee, the Attorney General, the Lord Advocate, Sir Robert Armstrong and First Parliamentary Counsel.

Yours

John Biffen

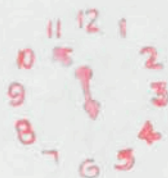
JOHN BIFFEN

The Rt Hon The Lord Cockfield
Secretary of State for Trade
1 Victoria Street
London SW1H OET

CONFIDENTIAL

Ind Pol Oct 49
Companies Bill

1983



CONFIDENTIAL

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

Prime Minister

To see. Early legislation is required to put right a loophole in the Companies Acts, whereby a large number of pensions and other funds are found to have no good title to their assets.

MCS 4/5

Colin Walters Esq
Private Secretary
Home Secretary's Office
HOME OFFICE
50 Queen Anne's Gate
London
SW1H 9AT

3 May 1983

Dear Colin,

My Secretary of State wrote to the Lord President on 26 April outlining the importance of early primary legislation this session to cover a very serious technical problem which has arisen relating to the application of certain provisions of the Companies Acts to pension schemes, employee share schemes and similar schemes for the benefit of employees. His letter was initially given a relatively limited circulation. Following the Home Secretary's 28 April letter to the Secretary of State, I am now copying this letter more widely to those suggested, and to Michael Scholar at No. 10.

I am also enclosing a memorandum explaining the background to the problem and our legislative proposals in more detail.

As the Secretary of State's letter of 26 April states, knowledge of the problem, which only came to light relatively recently, is at present being closely held. Once it became clear that the necessary legislation could not be incorporated in the Finance Bill, we received confirmation from the Attorney General last month that the problem could only be put right by independent legislation. It was as a result of this that the Secretary of State sent his letter to the Lord President.

It is important that knowledge of the problem should not spread more widely until the Government is in a position to remedy the situation. Until such action can be taken, there is an ever-present risk of a pension fund trustee or investor acting on the assumption that the ostensible owner of shares affected does not have good title to them. This could cause serious disruption and loss of confidence in the financial markets, and probably to the detriment of funds. It is because of this "time-bomb" character of the problem that the Secretary of State is seeking authority for very urgent legislation. For this reason, it would be particularly welcome if, as the Home Secretary suggests, the matter could be cleared without a meeting.

CONFIDENTIAL

From the Secretary of State

As noted, I am sending copies of this letter to Michael Scholar (No.10), the Private Secretaries to members of H Committee, the Attorney General, the Lord Advocate, Sir Robert Armstrong and to the First Parliamentary Counsel.

Yours sincerely,

JOHN RHODES
PRIVATE SECRETARY

CONFIDENTIAL

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephor

CONFIDENTIAL

From the Secretary of State

The Rt Hon John Biffen MP
Lord President of the Council
Privy Council Office
Whitehall
London
SW1A 2AT

26th April 1983

Dear John,

We are advised that legislation is urgently needed to sort out an unfortunate legal tangle which has arisen in the case of pension funds, employee share ownership schemes etc. The Attorney General's advice has been sought and he agrees.

The problem is as follows:-

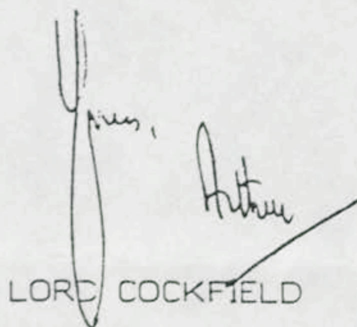
Investments owned by pension funds, employee share schemes etc are normally held by trustees. It is common practice for a company setting up such a fund or scheme to incorporate a subsidiary to act as trustee. If a "trustee/subsidiary" of this kind owns shares in the parent company, and if there is a residual interest in favour of the parent company as there normally will be, those shares are void. In the case of an employee share scheme it is of the essence of the matter that the trustees should hold shares in the parent company : and it is not uncommon in other cases as well. Legal advice is that unless expressly excluded the law presumes a residual interest in favour of the parent company : and in the case of approved schemes, the Inland Revenue demand that there should be such a residual interest. In the result a very large number of shares held by pension funds etc are void.

CONFIDENTIAL

From the Secretary of State

The problems goes back to 1947. It is surprising that attention should not have been drawn to the matter before. Fortunately at present very few people are aware of the situation : but it is not too much to say that a state bordering on panic already exists among those who do know. The reaction if the news spreads would be serious. There is, I am advised, no way of dealing with the matter other than by legislation. We hoped that this could be incorporated in the Finance Bill but this has not proved possible. Separate legislation would be required. This would be simple and would extend only to six substantive clauses. We would expect sucha Bill to be entirely non-controversial and therefore suitable for the Second Reading Committee procedure in the House of Commons and assured of rapid passage in the Lords. Obviously it will be necessary to confirm this by informal consultation before we proceed further. But if this can be cleared I hope very much that you and the Lord Privy Seal would agree to find time for such a Bill.

I am copying this to William Whitelaw as Chairman of H Committee as policy clearance will also be required, and to the Lord Privy Seal and the Chief Whips (Lords and Commons).



LORD COCKFIELD

CONFIDENTIAL

THE COMPANIES ACTS, PENSION SCHEMES AND EMPLOYMENT SHARE SCHEMES

Companies Act 1948, S.27

1. The problem with S.27 arises where a parent company has used a subsidiary company as a trustee of the company's pension scheme, employees' share scheme or any similar scheme for the benefit of employees, and those schemes hold shares in the parent company. S.27 is designed to stop a subsidiary holding shares in its parent, because this would enable the parent to control itself. By way of exception, however, S.27 permits a subsidiary to hold shares in the parent company if the subsidiary is concerned only as trustee and if the parent company is not beneficially interested in the shares.

2. It has long been common practice for companies to establish a subsidiary company to act as trustee of group pension, employees' share or other employee benefit schemes. Many such schemes have held and hold shares in the parent company as part of a pension scheme's investment policy, as a result of a merger of pension funds following a corporate merger or acquisition, by virtue of the very role of employee share schemes, or for other reasons. These two circumstances are only lawful in combination under S.27 if the parent company does not itself have a beneficial interest in the shares held by the schemes. Until recently, it was not appreciated that any such interest existed. However, it is now recognised that, unless there is express provision to the contrary in the terms of such a scheme, the parent company would under the equitable doctrine of "resulting trust" be entitled to receive back any surplus remaining in the scheme after the satisfaction of its objects eg. on the winding up of a pension scheme. Thus the parent company has a beneficial interest contrary to S.27 where any of its own shares are held by the scheme. Moreover in relation to schemes needing approval by the Inland Revenue, the Revenue insists that a term of the scheme should be that any eventual surplus should accrue to the parent company (and not, for example, be paid as a kind of untaxed bonus to others under the trust).

3. Since under S.27 any transfer or allotment of shares to a subsidiary in breach of the Section is void, the continuity of title to particular shares will have been breached in many particular cases since 1948. Moreover many present schemes must "hold" shares, in some cases given the practice of self-investment up to a sizeable proportion of the scheme's assets, to which they have no lawful title.

4. We do not believe that there has been any significant mischief in terms of company law as a result of these breaches of S.27. Those concerned and their advisers believed that they were acting within a permitted exception and no objectionable consequences of the breaches S.27 have come to light. It seems justified accordingly to legalise the void transfers or issues retrospectively.

Companies Act 1980, S.37

5. S.37(1)(d) of the Companies Act 1980 provides, in accordance with the EC Second Directive, that where shares in a public company are acquired with financial assistance from the company, and the company has a beneficial interest in those shares, the shares must be disposed of within one year or be cancelled, and must not be voted before

disposal or cancellation. Whether or not a company's employee share or pension scheme has a subsidiary as a trustee, the parent company will typically fund the scheme and, as described earlier, has a residual interest, if not expressly provided then on the resulting trust principle. Retrospective and prospective exemptions are therefore needed to S.37 similar to any provided in respect of S.27 of the 1948 Act.

Proposed Legislative Provisions

6. It is proposed to validate retrospectively and exempt prospectively transactions involving pension schemes and employee share schemes where any beneficial interest has been or is only a residual interest. Supplementary provision would be made to restrict the scope for abusing any such interest which vested in possession on satisfaction of the objects of the scheme.

10 DOWNING STREET

3rd March 1983

Dear Geoffrey,

Companies Buying Their Own Shares - Taxation

The Prime Minister has asked me to send you the enclosed note, which has been prepared by Alistair McAlpine.

Would you be kind enough, please, to let me have your comments?

IAN GOW

The Rt Hon Sir Geoffrey Howe QC MP

COMPANIES BUYING IN THEIR OWN SHARES

The object was to enable family or closely held companies to be no worse off if they sold shares on retirement or to pay C.T.T. when transferring shares to their family or (when dying!!) to their company rather than outside third parties thus destroying the family character of the business.

If they sell to outsiders there is no question but that the receipt is taxed as Capital. The Companies Act now permits companies to put in their own shares but the tax legislation starts from the premise that the receipts should be taxed as income, not as capital, unless the rich-on-paper family shareholder can get through the eye of the Inland Revenue's needle.

To do this he needs to qualify for the very limited number of permitted exceptions. The whole concept should be changed so that receipts are regarded as capital as is the cost in sales to outsiders.

If this is unlikely then the exemptions need drastic expansion. For instance:

1) To apply to close companies even if they have a quotation. They do apply now to companies whose shares are dealt with on The Unlisted Securities Market even if they are not controlled by family or associated shareholders.

   The dangers of an unwanted raiding new outside shareholder are vastly greater in a quoted close company than an unquoted company.

   Our own company has unquoted capital shares as well as quoted ordinary shares. The present rules take even our unquoted shares out of allowed categories which was surely not intended. Another company while none of their equity is quoted has quoted preference shares and this company also does not qualify.

2) The requirement that a shareholder must reduce his holding by 25% to qualify is reasonable enough but bringing in "associates" which bring in virtually all family members closely involved in running the company makes it near impossible to help those who it is aimed to help; e.g. a company wholly owned by, say, 4 associated people one of whom with 10% dies or wishes to retire. The company purchasing all his shares still does not qualify unless it buys in a further 15% from his associates who themselves are not retiring and whose holdings would, therefore, not qualify in their cases.

25/2/83

Ind. Pol.

MR. MOUNT

The Prime Minister agrees that you should pursue with the Treasury the possibilities set out in your recent note about wider share ownership.

SCHOLAR

18 November, 1982.

Prime Minister (1)

Agree that Ferdy pursues with the Treasury?

MLS 17/11

Yes M

17 November 1982

Policy Unit

PRIME MINISTER

WIDER SHARE OWNERSHIP

The Treasury (in the person of Nick Ridley) has reacted in a very negative spirit to the suggestion, put by Charles Bellairs to Ian Gow, that we ought to look at a Loi Monory type scheme if we are serious about promoting wider share ownership.

I would like to fire off the attached broadside. It is surely important that we should work up some practical proposals for the next Parliament. And I feel that, unless we put something in the Manifesto, it is one of those subjects that is liable to be shelved for all eternity. After 30 years of campaigning for wider share ownership, there are still only 2 million individual shareholders.

Alan tells me that earlier discussions with the Treasury came to nothing. Would you like me to pursue the possibilities with the Treasury?

Yes please

M

FM

FERDINAND MOUNT

17 November 1982

STIMULATING PERSONAL INVESTMENT IN EQUITIES

1. The Treasury's first objection to a proposal on the lines of the French Loi Monory is that they doubt "how far it would stimulate new investment, as opposed to investment which would happen anyway".

2. But this is not the sole, or even the crucial, aim of a Monory-type scheme. Those aims include:

   (a) to increase the number of individual shareholders;

   (b) to increase the proportion of equity shares held by individuals as opposed to corporate institutions;

   (c) to increase the proportion of individual wealth which is held in wealth-producing assets rather than in bricks and mortar or in loans to the Government; as well as

   (d) to add to the total volume of savings.

   Thus it would be perfectly possible for a Monory-type scheme to satisfy (a), (b) and (c) within the same overall volume of savings.

   We want <u>people</u> to own capital, not institutions. We would no doubt be delighted if the new scheme added to total investment - although we could not guarantee it - but that would be icing on the cake.

3. The Treasury is also dubious about introducing another distortion into the fiscal system when the purpose of this Conservative Government is to reduce such distortions. But we must be realistic. Those other distortions - in favour of house purchase and life assurance premiums - are not going to disappear overnight, if ever.

   As a result, what the system now says to people is in effect: "We shall help you to buy a house or take out life assurance, but we shall actively discourage you from buying shares on your own account". Thus the system reinforces the Left-wing caricature of the Stock Exchange as an immoral casino and thus reinforces too the anti-enterprise culture.

This bias is a hangover from the days when trustees were legally barred from investing in equities. The United States and now France have understood how vital it is for a healthy economy to eliminate the bias.

4. Of course it would be practically impossible to try to confine relief to investment which would not otherwise have taken place. Other countries don't try to. And nor should we.

And nor should we become obsessive about closing loopholes and deterring "washing" operations. Simplicity and low administrative costs ought to be the aim.

5. There remains only the "deadweight" question - the cost to the Revenue of subsidising existing shareholders. Even this has merits as well as the considerable demerit of revenue foregone.

In effect, to the better-off such a subsidy is equivalent to a reduction in the investment income surcharge - which we all would like to see abolished. But it is much more politically acceptable because it would apply equally to the small saver as well.

6. We might have to start small - with an annual limit in the region of the £500 Monory limit rather than the £1,000 instanced by the Treasury. Even that would build up to a useful little nest-egg within a decade.

But the point is one of principle: that the tax system should begin to treat as rough equals savings for investment in industry and savings for house purchase and for funding the Government's debts. As the Chairman of the Investment Trust Association reasonably argues: "fiscal neutrality is not too much to ask of a Government whose stated policy is the encouragement of free enterprise and the reward of individual initiative".

7. If the Monory scheme is thought to be too wide-ranging, then there are two alternative candidates which might be easier to police:

(i) Self-administered pension schemes. The individual sets up his own scheme, using a standard trust deed, appointing a professional trustee, allocating an agreed proportion of his

income to be invested as he sees fit. This would be a question of adapting to employees the model currently open to controlling directors of companies.

(ii) Premium relief for individual investment in unit funds. The individual buys units in funds managed by insurance companies or investment management groups and obtains a certificate to show the tax inspectors. He would be free to switch his investments, but not to withdraw the cash and spend it.

8. No doubt plenty of variations on these ideas could be considered. But unless we do something to correct the bias in the tax system, wider share ownership will remain a pious hope, the pension funds will grow still fatter and more slothful, and the popular distrust of capitalism will persist.

9. I suggest that:

(i) a dramatic scheme for encouraging individual investment in industry ought to be a prime candidate for the Manifesto; and

(ii) the Treasury should prepare a list of options.

FM

FERDINAND MOUNT

10 DOWNING STREET

From the Principal Private Secretary 28 June 1982

Dear John,

CIVIL LIST ACT 1952 and COMPANIES ACT 1982

I have shown the Prime Minister your letter of 21 June 1982, and she is grateful for this explanation of the events which led to your Secretary of State's last-minute approach to her and the Chancellor of the Exchequer seeking their agreement to their direct exemption as Trustees under the Civil List Act 1952.

I am sending a copy of this letter to John Kerr (HM Treasury).

Yours ever,

Clive Whitmore.

John Rhodes, Esq.,
Department of Trade.

LETTERCODE/SERIES PREM 19 PIECE/ITEM 1064 (one piece/item number)	Date and sign
Extract/Item details: Letter Rhodes to Whitmore dated 21/6/1982	
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CONFIDENTIAL

10 DOWNING STREET

File AH
cc Tsy
Ind Pol

From the Principal Private Secretary

14 June 1982

Dear John,

CIVIL LIST ACT 1952 AND COMPANIES ACT 1981

As I told you on the telephone earlier today, the Prime Minister and Mr Thatcher have indicated that they are ready to accept the arrangements proposed by your Secretary of State and set out in your letter of 11 June 1982.

The Prime Minister would, however, like to be told why it was that this complex issue, which affects her and Mr Thatcher in a personal capacity, came to be put to her so very late in the day. She would be grateful if your Secretary of State could let her have an explanation.

BK

I am sending a copy of this letter to John Kerr (Treasury).

Yours ever,

Clive Whitmore.

John Rhodes Esq.,
Department of Trade.

AH

CONFIDENTIAL

LETTERCODE/SERIES PREM 19 PIECE/ITEM 1064 (one piece/item number)	Date and sign
Extract/Item details: Letter Kerr to Rhodes dated 14/6/1982	
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From: D R Collinson

Date: 11 June 1982

MR J KERR

cc Sir Douglas Wass
Mr F E R Butler
Mr G Hosker
Treasury Solicitor
Mr C Whitmore No.10

COMPANIES ACT 1981 AND ROYAL TRUSTEES UNDER THE CIVIL LIST ACTS

I was invited late on Thursday, 10 June to a meeting at the Department of Trade which revealed that it will be necessary for both the Prime Minister and the Chancellor to agree to the Secretary of State exempting the Prime Minister and the Chancellor and their spouses from the obligation to respond to any enquiries by companies under the Companies Act 1981.

2. I have since discussed the matter with the Treasury Solicitor (Mr Hosker) who has seen the proposed draft submission from the Department and is content.

3. Unfortunately, for reasons which are explained in a letter from the Private Secretary to the Secretary of State (paragraph 11 of the rough advance draft attached - top copy only), it is necessary to know on Monday 14 June that the Chancellor and Lady Howe (and the PM and Mr Thatcher) are content.

4. I recommend the Chancellor to agree for official reasons, but I feel bound to add that the proposal raises personal, as well as official considerations.

5. I attach photostats of the relevant Clauses [4(2) and 10] of the Civil List Act 1952 for ease of reference.

CLOSED UNDER THE
FREEDOM OF INFORMATION
ACT 2000

D.R.C.

D R COLLINSON

Civil List Act, 1952

4.—(1) There shall be paid to the trustees hereinafter mentioned as a provision for the benefit of the children of Her present Majesty, other than the Duke of Cornwall for the time being, yearly sums of the following amounts, that is to say—

Provision for Her Majesty's younger children.

(*a*) in respect of each such child who either attains the age of twenty-one years or marries, ten thousand pounds in the case of a son and six thousand pounds in the case of a daughter, and further

(*b*) in respect of each such child who marries, fifteen thousand pounds in the case of a son and nine thousand pounds in the case of a daughter,

to commence from the date of his or her attaining that age or marrying (whichever is the earlier) in the case of a sum falling within paragraph (*a*), and from the date of his or her marrying in the case of a sum falling within paragraph (*b*):

Provided that the sum payable in respect of any such son or daughter shall cease to be paid on the death of that son or daughter.

(2) The trustees shall hold the yearly sums paid to them under this section in trust for all or any one or more of the children of Her present Majesty, other than the Duke of Cornwall for the time being, in such shares, at such times, in such manner and subject to such conditions and powers of revocation (including, if it is thought fit, a condition against alienation) as Her present Majesty may by order, countersigned by the First Commissioner of Her Majesty's Treasury and the Chancellor of the Exchequer, appoint:

Provided that any such appointment may be varied by another order made and countersigned in like manner.

10. The persons who are for the time being the First Commissioner of Her Majesty's Treasury, the Chancellor of the Exchequer, and the Keeper of Her Majesty's Privy Purse shall be the Royal Trustees for the purposes of this Act, and shall be a body corporate by that name, and any act of the trustees may be signified under the hands and seals of the persons who are the trustees for the time being.

Constitution of Royal Trustees.

The National Archives

LETTERCODE/SERIES PREM 19 PIECE/ITEM 1064 (one piece/item number)	Date and sign
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ANNEX A

96 Mr Arthur Blenkinsop (South Shields): To ask the Secretary of State for Trade, whether he has granted any exemptions under section 27(9) of the Companies Act 1976; and if he will make a statement. ¶

MR. S. CLINTON DAVIS

The Secretary of State has granted one exemption under section 27(9) of the Companies Act 1976, in favour of Bank of England Nominees Ltd, a wholly owned subsidiary of the Bank of England. Bank of England Nominees Ltd have given a number of undertakings about the use to be made of the exemption. They will hold securities as nominee only on behalf of Heads of State and their immediate family, Governments, official bodies controlled or closely related to Governments, and international organisations formed by Governments or official bodies. They will in turn seek certain assurances from anyone in the eligible categories who wishes them to hold securities as that person nominee; these assurances are to cover (a) the fact that the person is the beneficial owner of the securities to be held by Bank of England Nominees Ltd; (b) that the beneficial owner will not use his interest in any securities held by Bank of England Nominees Ltd to influence the affairs of the company in which shares are held except as shareholders in general meetings of that company; (c) that the beneficial owner is awae of his overriding obligation, under section 33 of the Companies Act 1967 as amended, to disclose his interest to the company in which shares are held if he is interested in 5% or more of that company's share capital.

Bank of England Nominees Ltd has also undertaken to make a report annually to the Secretary of State for Trade of the identity of those for whom it holds securities, and, provided thatit holds securities for two or more people, thetotal value of the securities held. The contents of such reports are to be confidential to the Secretary of State.

ANNEX B

CONFIDENTIAL

SCHEDULE C

UNDERTAKING FROM AUTHORISED AGENT OF PERSONS MENTIONED IN PART II

To : The Directors
Bank of England Nominees Limited
19 Old Jewry
London
EC2R 8AH

Gentlemen,

In consideration of Bank of England Nominees Limited ("the Nominee") agreeing to hold certain securities (including Relevant Securities as defined below) in which [ ] ("our Principals") are interested we hereby make the representations and give the undertakings and authorities set out in the following clauses:-

1. In these clauses:-

(a) "exempt person" means a person who is for the time being exempted by the Secretary of State under Section 77(7) of the Companies Act 1981;

(b)

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FREEDOM OF INFORMATION
ACT 2000

(c) "Relevant Securities" means shares comprised in relevant share capital of a public company within the meaning of Part IV of the Companies Act 1981 and any other securities in relation to which Section 74 of that Act applies as it applies in relation to shares by virtue of subsection (6) of that section; and references to an interest in such securities shall have the same meaning in relation to such securities as references to an interest in shares have effect in relation to shares under Section 74 of that Act, and cognate expressions shall have effect accordingly;

provided that any interest in securities which a person would have (apart from this paragraph) by virtue of section 66(1) of that Act (interests in shares to be attributed to a person's spouse or, in the case of infant children, parent) shall be disregarded for the purposes of these clauses; and

(d) references in these clauses to provisions of the Companies Act 1981 shall be construed as including references to any statutory amendment or re-enactment thereof for the time being in force.

2. We confirm that we have been duly authorised by our Principals to act as their agents for all purposes arising out of the arrangements covered by these undertakings. Should this authority at any time be withdrawn or modified, we will forthwith notify the Nominee in writing.

3. Except under the conditions set out in clause 4, our Principals will remain interested in all those Relevant Securities which the Nominee may from time to time hold in which they are interested at all times that they are so held by the Nominee -

(i) as beneficial owner,

(ii) as beneficiary under an exempt trust, or

(iii) as trustee of an exempt trust

and no other person or persons other than beneficiaries or trustees of any such trust has or will have any interest in the Relevant Securities when they are so held, except for any interest which may for the time being arise from an agreement to sell or otherwise dispose of any such Relevant Securities.

4. If our Principals cease to be the beneficial owners of any of the Relevant Securities or, as the case may be, any such securities cease to be subject to an exempt trust when they are held by the Nominee on behalf of our Principals or if any other person except a beneficiary or trustee of any such trust acquires an interest in any of them when they are so held, we will as soon as reasonably possible notify the Nominee in writing and, except where any interest in Relevant Securities transferred is transferred solely for the benefit of an exempt person, give instructions in due course for the Nominee to transfer such Relevant Securities out of its name.

5. In the case of Relevant Securities held by the Nominee on behalf of our Principals as trustees of an exempt trust we will forthwith inform the Nominee of any actual or proposed change in the trustees of such trust.

6. We irrevocably authorise the Nominee to transfer at any time and at its discretion any or all of the Relevant Securities the Nominee may from time to time hold pursuant to this undertaking in which our Principals are interested into our name or the name of another person interested in the securities so transferred or the name of a nominee specified by us.

7. We are aware of our Principals' obligations under sections 63 to 72 of the Companies Act 1981. We understand that our Principals' obligations thereunder (which include the obligation to notify to public companies certain interests in the share capital of such companies) remain notwithstanding that our Principals are exempt persons.

8. Our Principals will not use their interest in any of the Relevant Securities held by the Nominee to influence the affairs of any company issuing any such Relevant Securities except in the general meeting of such company.

9. We will, and we will procure that each of our officers, employees, agents and advisers will treat as confidential the contents of this agreement and the arrangement herein contemplated and in particular the fact that the Nominee holds or has held or will hold any Securities in which our Principals are interested.

10. We authorise you to disclose to the Secretary of State for Trade the fact that the Nominee holds or has ceased to hold securities in which our Principals are interested.

Yours faithfully

For and on behalf of

[Agent]

The National Archives

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Treasury Chambers, Parliament Street, SW1P 3AG

M A Pattison Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

24 September 1981

Dear Mr Pattison

PURCHASE OF OWN SHARES

I attach for information a copy of a consultative paper on the tax treatment of companies purchasing their own shares. This was foreshadowed in the Chancellor's Budget speech (Hansard, 10 March 1981, Col 780). The Revenue hopes to publish the paper tomorrow or on Monday.

Yours sincerely

M C FELSTEAD
Private Secretary

COMPANIES PURCHASING THEIR OWN SHARES

IMPLICATIONS FOR CORPORATION TAX, INCOME TAX AND CAPITAL GAINS TAX

PART I : THE ISSUES FOR DISCUSSION

A. INTRODUCTION

Proposed changes in company law

1. The Companies (No 2) Bill currently before Parliament contains provisions enabling companies, if authorised by their Articles, to purchase their own shares and to issue redeemable shares, subject to certain safeguards. In general, shares may only be purchased or redeemed out of distributable profit or the proceeds of a fresh issue; but there are certain further provisions for private companies. A summary of the proposals in the Companies (No 2) Bill is at Annex I.

Background

2. These proposals in the Companies (No 2) Bill follow the issue of a Green Paper in June 1980 by the Secretary of State for Trade. In paragraph 11 of that Green Paper the then Secretary of State said:

> "Treasury Ministers will be considering in a separate review the case for easing the tax charge in certain classes of case, where this could help to make possible a desirable increase in the flexibility of company organisation."

Purpose of the consultative paper

3. This consultative paper accordingly discusses possible changes in the tax treatment of certain payments made by companies when purchasing etc their own shares, and whether

such payments should be exempt from the present tax provisions dealing with distributions of profits (involving liability to advance corporation tax and income tax), and should be left to be handled under the rules for capital gains tax.*

4. It concentrates in the first instance on the main case, where shares are purchased or redeemed out of distributable profits. A subsequent section (paragraphs 39 to 46) discusses the question whether a distinction should be made between that case and the case where shares are purchased or redeemed out of capital.

B. IMPLICATIONS FOR TAX

Existing legislation

5. The existing rule for tax is broadly that, when a company distributes profits to its shareholders, the distribution is treated as a payment of income by that company and a receipt of income by the shareholders. Thus, the company pays advance corporation tax (ACT) and the distribution is taxed as income (with a tax credit attached) in the hands of the shareholders.

6. This rule applies both generally, and in the special situation when under existing tax law a company uses surplus profits** to purchase its own shares (as certain kinds of companies already can, even under the existing companies legislation). By contrast, in normal circumstances when a capital asset such as an equity share is sold and bought, any gain in the hands of the seller - generally the difference between what he pays and what he gets - is subject to tax under the capital gains tax rules.

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* The paper does not discuss other more technical changes in tax legislation which may need to be considered in the light of the new companies legislation.

**Excluding amounts representing the return of the original capital.

7. This difference of treatment follows from the difference in the nature of the two transactions, as they relate to the structure of company taxation:

a. In the former case, it is of the essence of the thing that profits pass out from the company to the shareholder concerned.

b. In the latter case, there is a transfer of a valuable capital asset between one (old) shareholder and another (new) shareholder; and no profits pass out from the corporate sector.

8. Conversely, in the latter case there is a reduction in the (old) shareholder's interest in the company; this may or may not be so in the former case.*

9. It depends on the circumstances and status of the various shareholders (whether for example they are individuals or companies) whether the former treatment implies a larger or a smaller tax bill than the latter.

10. The general principle underlying this treatment is that the same consequences should follow, whenever a continuing company distributes profits to its shareholders, irrespective of the form which the distribution takes.

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*The obvious limiting case is the one-man company:

a. if the company purchases 50 per cent of his shares, he remains the 100 per cent owner of the company; but he has cash which was previously held by the company

b. if someone else purchases 50 per cent of his shares, he ends up with only a half interest in the company; and the company has paid out none of its accumulated cash.

The same effects obviously apply, mutatis mutandis, where shares are more widely held.

C. SCOPE OF THE GOVERNMENT'S PROPOSALS

11. For the reasons outlined in paragraphs 7 to 10 above - and because of the possible implications for the present yield of tax on dividends of some £m500* - the Government see no case for simply substituting capital gains tax treatment for the present tax treatment in all cases where a company purchases its own shares; in particular, in cases where the main object of a company doing so is to distribute surplus profits to its shareholders.

12. On the other hand, the Government believe that in certain situations a change in the present tax treatment can add significantly to the new flexibility proposed in this year's Companies Bill. In introducing his "enterprise" measures to help small firms, in this year's Budget Statement, the Chancellor of the Exchequer said:

> "As the House know, the Government will shortly introduce new clauses in Committee on the Companies Bill, to enable companies to purchase their own shares. Corresponding changes are needed in the present tax structure to help with a number of problems arising in small and family businesses. I am, therefore, asking the Inland Revenue to issue a consultative document on this subject this summer, with a view to legislation in next year's Finance Bill."**

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* This takes account only of those dividends to shareholders who could benefit from a change in tax treatment. Most corporate and some other shareholders would probably prefer the present tax treatment to having any gain on disposal made subject to the capital gains tax rules.

**Official Report 10 May 1981, column 780.

D. CHANGES AFFECTING CERTAIN CLASSES OF CASE

13. The issue discussed in this consultative document is how to define the "certain classes of case" referred to in the 1980 Green Paper,* and further developed in the 1981 Budget Statement,** where the present tax treatment should be changed.

14. The new legislation for this purpose may have to address itself to more difficult questions than the present legislation on distributions. The present provisions*** look to the relatively simple question: is there a distribution of profits? The new legislation may have to go on to ask: if so, in what circumstances and for what purpose is the distribution being made?****

15. It is implicit in the fact that this consultative document is being published, that the Government believe that the benefits of greater flexibility in this area will in certain important instances be sufficient to outweigh this extra complexity. So far as possible, however, tax rules need to be both simple and certain in operation. In each case at the margin it will be necessary to balance the economic advantages of greater flexibility against the economic costs of possible distortion or avoidance, and of complicating an already complex system of business taxation.

16. Thus, in considering possible specific suggestions for change, 4 main questions may arise:

a. What reasonably clear economic or commercial benefit would follow from a change in the tax rules?

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* See paragraph 2 above.

** See paragraph 12 above.

*** Part X and Section 284 of the Taxes Act 1980.

****In this respect, it will be moving into the kind of field (though not of course precisely the same field) which is presently the concern of Section 460 of the Taxes Act.

b. Is this benefit reasonably clearly distinguishable from the general benefits when a company pays out surplus profits to its shareholders?

c. Is the case capable of being defined reasonably clearly in legislation?

d. Could it be recognised reasonably clearly in practice?

17. The Government's purpose, in issuing this document, is to expose the issues for public discussion, and to invite comments which will help them to decide the form in which, should a consensus emerge, they should bring forward legislation in the 1982 Finance Bill.

18. The consultative document seeks at this stage to concentrate on the broad issues for discussion, leaving aside for the time being most of the technical details with which any legislation would have to deal. But the Government would, of course be glad to receive comments or suggestions on any aspects of a possible change.

19. Where it is possible to arrive at a reasonably clear and workable definition of special "classes of case" for the purposes of this legislation, the question will arise whether it is necessary, or desirable, to restrict the special tax treatment to the occasions when a company purchases its own shares. The question could arise whether the same treatment should be extended to the cases where, in similar underlying circumstances, the company finds it preferable on broad commercial grounds to redeem shares or to reduce share capital in the course of a company reconstruction. This again is a matter on which the Government will welcome comments.

PART II : IMPLICATIONS FOR POSSIBLE NEW LEGISLATION

E. POSSIBLE AREAS FOR SPECIAL TAX TREATMENT

20. The 1980 Green Paper sought to list* the main advantages which had been suggested for allowing companies to buy their own shares; but the Government would, of course, be ready to consider other suggestions. The Green Paper emphasised that the case for changes in company law stood independently of any changes in tax law.

21. Some of the possible objectives listed in the Green Paper are not within the intention of the new companies legislation (for example, the opportunity for a company to make money by trading in its own shares). Others are relevant to the general tax treatment of distribution of profits, rather than to the special case when a company purchases its own shares (for example, to provide a company which has surplus cash with a further means of using it to the advantage of its shareholders.**)

22. An example of the latter is perhaps the case where a share purchase could result in a company's shareholders retaining something close to their ex ante percentage shareholding in the company, or where shares are purchased from a dominant shareholder or group of shareholders who retain ex post a dominant interest in the company. In these kinds of case it appears reasonably clear that the effect of the share purchase is essentially equivalent to a dividend or distribution of profit.

23. In other cases again, the existing tax rules are no obstacle to the aim identified in the 1980 Green Paper (for

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* Cmnd 7944, in particular paragraphs 11 and following.

**See paragraphs ~~8 and~~ 11 to 18 above.

example, in the straightforward case* where a company buys up redeemable preference shares before redemption, at a time when they are quoted at below the redemption price).

24. However, experience over the past decade or so and the response to the 1980 Green Paper suggest that 5 main types of situation are thought to stand out, where a change in the tax treatment, when a company purchases its own shares, could help certain kinds of trading businesses to manage their affairs more flexibly and efficiently:

- First, the facility could encourage people to buy the company's shares. As things stand, outside investors can be reluctant to invest in the equity of the kind of business for whose shares there is no ready market, and the potential investor can be reluctant to accept the risk of being "locked in".

- Second, it could make it easier for the proprietor of a business to seek equity investment from others. In some cases, an entrepreneur can be unwilling to surrender a permanent equity stake.

- Third, it may contribute to the efficient management of the business, if dissident or apathetic shareholders can be bought out. Again, in some cases there may be no ready market for the shares in question, and the other shareholder or shareholders may not have sufficient free capital to buy out the dissenting interest.

- Fourth, when a family shareholder with a significant number of shares retires or dies (and there are no children to succeed him), the other members of the family may not be able to afford to buy out his shares. There may be cases where the only option is to sell shares to a third party and - where this results in loss of family control - it could have harmful effects on the company's trade.

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*There is in general no income tax charge when a company purchases or redeems shares at a price equal to less than the price at which they were issued.

- Fifth, a very similar situation can in principle arise when the shareholder dies, and there is no alternative to the estate selling shares, if CTT liabilities are to be met.

25. The Government would welcome comments on these five situations. How far are they themselves important for the efficient and flexible management of a trading business? And how far do they cover the main areas of potential beneift?

F. POSSIBLE NEW LEGISLATIVE PROVISIONS

26. It would be premature to draft specific new legislative proposals in advance of public comment on the questions raised in Section E and paragraph 25 above. But two approaches seem to merit consideration.

(Old para. 27 deleted)

27. One approach might be to seek to define each of the "special classes of case" individually. On the face of it, this could present difficulty. To take only 3 examples, how in practice would one define the "reluctant investor" (the first case in paragraph 24 above), the "unwilling proprietor" (the second case), or the "dissident shareholder" (the third case) for the purposes of a taxing statute?

28. A more promising approach might be to look for common features, which the legislation could use in a more general way to identify the "special classes of case" for which it was desired to change the present tax ~~system~~ treatment, and to distinguish them from other cases where the effect of a company purchasing its own shares would predominantly be a distribution or paying out of surplus profit.

29. It may be helpful to illustrate an approach of this kind in terms of the 5 main types of case listed in paragraph 24 above. It may be thought that they are trading business which have 3 main features in common.

30. First, they are all cases which arise because the shares of the company in question are closely held and/or where there is no ready market in which a shareholder can be confident of selling a possible minority shareholding, when he wishes, at a fair price. By contrast, shares quoted on the Stock Exchange, may be sold fairly readily - though obviously the price which shares fetch at any time may be affected by such things as the size of the shareholding and by current market conditions.

31. In general, it may be felt therefore* that these are essentially problems for the unquoted company, as distinct from the company whose shares are widely held and quoted on the Stock Exchange. The Government would welcome views, in the light of any comments expressed on Section E above, whether this might represent one possible criterion for new legislation. If so, it would be for consideration whether the distinction should be between public and private companies, or between "quoted" and "unquoted". If the latter, it would also be for consideration how to treat shares of companies quoted on the Unlisted Securities Market and on the over-the-counter "Nightingale" market. It is not clear how relevant the former would be.

32. Second, they all seem to be cases in which the shareholder parts with his interest in the company, either by selling his shares, or on death. This itself may tend naturally (in the case of the more narrowly held and unquoted company) to distinguish cases of this kind from the cases (cf paragraph ~~24~~ 22 above) where the effect of a company purchasing its own shares is evidently equivalent to a dividend or a distribution of surplus profits.

33. It may also be that, when a shareholder and his associates cease to have any interest in the company, there is substantially less risk that a tax easement will be misused.

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*cf the 1981 Budget Statement, paragraph 12 above.

34. The Government would therefore welcome views whether it might be a further criterion of new tax legislation, that the shareholder whose shares are being purchased should part with his interest in the company.

35. If so, consideration would need to be given to the definition of "parting with a shareholder's interest". As it stands, the implication is that the shareholder should part with the whole of his interest. This would seem likely to be the most simple approach, both legislatively and administratively (see paragraph ~~34~~ 32 above). Would there be major problems with this approach, or would there be major commercial difficulties if the legislation did not provide for the more complicated situation where the shareholder may very substantially reduce his percentage shareholding in the company, but still retain a very much reduced (and not dominant) interest?

36. Consideration would also need to be given to the detailed provisions necessary (for example) to identify the genuine case where an investor has held his shares for some minimum period (say normally 5 years) before the share purchase (as distinct from the case where, perhaps, some person moves in just long enough to strip out surplus profits), and also to provide for the case where the investor maintains or reacquires an effective interest in the company subsequent to the share purchase (for example, by retaining an option to re-purchase his shares after the event, or by maintaining an interest in the hands of his close associates or through companies under his control).

37. <u>Third</u>, the cases in paragraph 24 seem to relate mainly, if not wholly, to investment by individuals resident in the UK. To introduce special rules for the taxation of purchases of shares held by shareholders other than individuals would seem likely to raise significant new complications.* To extend the same

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*and could also be generally to the shareholder's disadvantage - see paragraph ~~8~~ 9 above. Corporate shareholders - and the related problem of shareholdings held by nominees are most common in - though by no means exclusive to - quoted companies.

treatment to non-resident shareholders would raise different issues, to the extent that the proceeds of the share purchase or redemption would not generally be subject to the alternative charge to capital gains tax, and the profit distribution would therefore be free of all UK tax. The Government would welcome comments on the implications for these further categories of cases.

38. Clearly, no one of the three common features listed above would be sufficient, by itself, to distinguish the "classes of case" which might qualify for the proposed new relief from other cases where the existing rules should apply. Thus, for example,

a. Obviously an unquoted company may use a share purchase or redemption to distribute accumulated profits to its shareholders.

b. In the case of a quoted company whose shares are widely held, it may be that there is a less helpful distinction between buying out all of some shareholdings,* as against buying out some of all shareholdings. In each case the substance of the matter may be that the company makes a profit distribution equal to a given percentage of the equity capital.

The Government would however welcome comments on how far the three common features discussed in these paragraphs might go to form the basis of a rule for distinguishing certain classes of case for the proposed relief, when taken together.

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*Shares which are sold receive accumulated profits from the company; shares which are not sold may (as explained in page 10 of the 1980 Green Paper) become more attractive investments for that reason. This note does not deal with the question whether in this kind of case the rules of the Stock Exchange and the Companies Acts provisions in relation to insider trading are likely to require such a company making any substantial purchase of its own shares to give all shareholders an opportunity to benefit equally. Nor does it deal with the other practical implications that will arise in this area, irrespective of any changes of the kind discussed in these paragraphs.

(Some technical points of company law are still being checked in these paragraphs) C J

G. ALIGNMENT OF TAX LAW WITH COMPANY LAW

39. The preceding sections of this note have discussed the question whether in "certain classes of case" the capital gains tax rules (not ACT and income tax) might apply. There is a more radical question whether, in cases of repurchase or redemption of shares, the basic rax rules should be restructured to follow the new company law rules.

40. As tax law now stands, the basic rule (elaborated in several pages of other legislation dealing with bonus issues, company reconstructions etc) is that only the excess over the repayment of the original capital subscribed is treated as a distribution, and liable to ACT and income tax accordingly.

41. In the main case, the new Companies Bill may be thought consistent with this. Clause 43(5)(b) of the Bill provides that ~~any payment of this excess (~~"any premium payable on redemption*"~~)~~ must normally be paid out of distributable profits. This applies even where the repurchase is being effected out of the proceeds of a fresh issue of capital. A "premium" in Companies Bill terms however is always the excess over the nominal value, which may not be the same as the excess over the amount subscribed.

42. The Bill goes on however to make 2 exceptions. The first applies where the shares being repurchased were themselves issued at a premium (Clause 43(6)). In that case, "any premium payable on their redemption" may be paid out of the proceeds of a fresh issue of shares made for the purpose up to the lesser of the premiums originally received by the company on the shares of which some are being repurchased and the current amount of the company's share premium account including any premium on the new shares. So far as "any premium payable on their redemption" can include a premium in excess of the

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*The same rules apply for repurchase as apply for redemption.

premium at which the shares were issued, this is a case in which the excess over the subscription price may be paid out of capital (though not so as to effect a net reduction in capital reserves).

43. The second exception (Clause ~~49~~ 50) is where the repurchase is effected out of existing capital; this is allowed in the case of a private company whose Articles so provide after it has exhausted available profits and the proceeds of any fresh issue.

44. The question arises whether as a general rule, the tax provisions should be radically restructured in line with the new proposals in the Companies Bill so that (a) where shares are redeemed or repurchased (but not otherwise) any part of the excess over the original subscription price which was treated under company law as paid out of share premium account or out of capital would not be treated as a distribution of profits; (b) where company law treats the whole of the repurchase price as paid out of distributable profits, the whole should likewise be treated for tax purposes as a distribution (and not, as now, only the excess over the amount subscribed).

45. In either case, the new rule would not apply in the "certain classes of case" discussed in paragraphs 20 to 38 above. In those cases, irrespective of the company law treatment, the whole payment would be brought in for purposes of capital gains tax as consideration for the disposal of the shares.

46. The Government would welcome comments on this more radical approach. If it is thought to have merit, the Government would also welcome comments on the implications for associated areas of tax treatment, in particular:

a. for the consequence that a different tax liability would follow, where on the one hand a company redeemed its shares under the new proposals in the Companies Bill,

and on the other hand, the company made use of the existing provisions to go to the Courts for a reduction in share capital; and

b. for the consequences if new shares issued to finance a share purchase or redemption were themselves subsequently purchased, redeemed or otherwise repaid. The logic of the proposals seems to require that they should in effect be treated as "standing in the shoes" of the shares whose place they have taken: that is, as if the amount of new capital subscribed for those shares should (where necessary) be treated as reduced or increased to equal the amount of new capital subscribed for the original shares.

H. SUMMARY

47. The Government invite comments on the case for exempting from advance corporation tax and income tax payments made in certain defined classes of situation by companies when purchasing their own shares, leaving these to be handled under the rules for capital gains tax (paragraphs 17 and 18). The Government also invite comments on whether, if it is possible to arrive at a reasonably clear and workable definition of such "classes of case", it would be necessary or desirable to restrict special tax treatment to the occasions when a company purchases its own shares, or whether the same treatment should be extended to the cases where, in similar underlying circumstances, the company finds it preferable on broad commercial grounds to redeem shares or to reduce share capital (paragraph 19).

48. On specific points discussed in this consultative document, the Government invite comments on:

a. The extent to which the 5 main types of situation discussed in paragraph 24 cover the main areas where a change of tax treatment would be of potential benefit to trading businesses - in a way which could clearly be

distinguished from the general benefit such businesses might expect to derive from an easing of the tax charge on distributions of profit; or whether there are other comparably important areas of potential benefit (paragraph 25).

b. Whether a helpful common feature - in identifying cases of this kind and distinguishing them from the cases where the purchase of own shares might more commonly be equivalent in effect to a distribution of profit or dividend - might have reference to the facts that the companies making the payments in question are private or unquoted, and that the people receiving the payments are UK resident individuals who are parting with their interests in the company and consequential points of detailed interpretation (paragraphs 31 to 38).

c. Whether there is a case for any more radical restructuring of the tax treatment in other cases when companies purchase or redeem their own shares, to bring them more directly into line with the apparent implications of the new Companies Bill - again with their consequentials for other parts of the tax law (paragraphs 39 to 46).

Hitherto, except in certain very limited circumstances, limited companies in the United Kingdom have not been permitted to purchase their own shares. This position will be changed when the Companies (No.2) Bill currently before Parliament is enacted. The Government considers that the facility to purchase own shares would provide companies with valuable additional flexibility which might be used to contribute to the continuity and further development of companies, and to the deployment of corporate resources to the best effect. The Bill accordingly contains provisions enabling companies, if authorised by their articles, to purchase their own shares, and to issue redeemable shares, subject to safeguards for creditors and members.

The main conditions for redemption or purchase provided for in the Bill (on completion of its Committee Stage) are:

(i) Subject to (v) below, shares may only be redeemed or purchased out of distributable profits (that is profits that are available for distribution within the meaning of Part III of the Companies Act 1980) or the proceeds of a fresh issue;

(ii) Shares redeemed or purchased are to be treated as cancelled on redemption or purchase, and the amount of the company's issued share capital reduced by the nominal value of those shares. The amount of this reduction is to be transferred to a capital redemption reserve. Special provisions apply where shares are reduced or purchased out of capital (see (v) below).

(iii) Purchases of own shares must be authorised by the members. In the case of off-market purchases (that is shares purchased off a recognised stock exchange, or shares purchased on such a stock exchange but which are not listed or not subject to a marketing arrangement (as defined in the Bill), the Bill requires the purchase and the terms of the contract of purchase to be authorised by special resolution of the company. The Bill requires other purchases, that is market purchases, to be authorised by the company in general meeting. In this case, the authorisation may confer general authority, but it must specify the maximum number of shares to be purchased and the maximum and minimum prices which may be paid. The terms of any proposed contract pursuant to which a company may become entitled or obliged to purchase shares must be authorised by special resolution on a similar basis to authorisations of off-market purchases.

(iv) After a purchase of own shares, companies must make a return to the registrar stating the number and nominal value of shares of each class purchased, and the date of their transfer to the company. In the case of public companies, the return must also give the aggregate amount paid by the company, and the maximum and minimum prices paid in respect of shares of each class purchased.

v) Private companies, if authorised to do so by their articles may redeem or purchase their own shares out of capital, that is otherwise than out of distributable profits or the proceeds of a fresh issue. The amount of the payment out of capital which may be made is the amount of the cost of the redemption

or purchase less any distributable profits of the company or the proceeds of any fresh issues made for the purpose. Any payment out of capital must be approved by a special resolution of the company. Before any such resolution is passed, the directors must make a statutory declaration with regard to the payment out of capital, and the company's actual and prospective ability to pay its debts. The statutory declaration must be accompanied by an auditor's report. Provision is made for a proposed payment out of capital to be given publicity, and creditors may apply to the court for the resolution to be cancelled.

Ind Pol.

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

Chancellor of the Duchy of Lancaster

PRIME MINISTER
See also the minutes from the Secretary of State for Trade and the Dept of Industry (below)
MJS 28/1

PRIME MINISTER

COMPANIES BILL

I chaired a meeting of Legislation Committee this morning which considered a memorandum by the Secretary of State for Trade (L(81)20) in which he sought approval for the early introduction of the Companies Bill. Some serious doubts were expressed about whether it would be wise to proceed with the Bill in its present state of preparation, and the Committee agreed that the matter should be referred to Cabinet for a final decision.

The draft Companies Bill circulated to the Committee has three main sections. It implements the EC Fourth Directive on Company Accounts, makes changes in the provisions for company and business names; including the abolition of the Register of Business Names, and makes a number of miscellaneous changes to company law designed, in particular, to deter fraud and to improve the efficiency of the companies registration office. The Secretary of State for Trade, however, told the Committee that he intended to add two sets of further provisions, first on the disclosure of interest in shares, and second, on the purchase by companies of their own shares, by way of Government amendments during the passage of the Bill through the House of Lords. It emerged from our discussion that policy agreement has not yet been obtained for the disclosure proposals, and that in neither case had instructions yet been given to Parliamentary Counsel. It is unlikely that the drafting of the new clauses can be completed before the end of February.

It was pointed out in discussion that the disclosure proposals would be highly controversial, that the sanctions suggested to enforce them might well be held to contravene the European Convention on Human Rights, and that the judiciary had not

yet been consulted on their practicability. The provisions on purchase of own shares should not be controversial, and will indeed be widely welcomed as helpful to small businesses, but they are nevertheless of major importance and will lead to considerable discussion, particularly in the Lords. Most members of the Committee felt that it would be wrong to contemplate introducing matters of such fundamental importance by way of amendments at Committee Stage in the House of Lords, and that although it had not proved possible to shorten the Bill as suggested by QL Committee, we should at least refrain from lengthening it.

The Secretary of State for Trade would be willing not to proceed with his proposals on disclosure in the present Bill, though he warned that it would be almost certain that the matter would be raised, and amendments on the subject would be put down at Committee Stage in the Lords. Both he and the Financial Secretary to the Treasury remained convinced that it was essential to include provisions on the purchase of own shares, a development which is fully in line with our policy on small businesses.

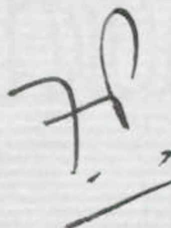
The business managers have always been worried about the implications for the legislative programme as a whole of trying to pass this long and complex Bill this Session. There have already been considerable delays in bringing the Bill forward, and their fears have been compounded by the discovery that the Bill is still incomplete, and is likely to be much more controversial, though not necessarily on party lines, than we were originally led to believe. Deleting particular provisions would shorten the Bill, but, because of the likelihood of non-Government amendments, would not necessarily reduce the amount of time needed for its consideration in both Houses.

My personal view is that the delays in drafting the Bill, the continuing uncertainty about the new matters which the Secretary of State wishes to add at a later stage, the unexpectedly

controversial nature of important parts of the Bill, combined with the other pressures on our legislative programme mean that it would now be unwise for us to risk going ahead with the Bill in the present Session. The immediate effect of postponing the Bill to the 1981/1982 Session would be to defer the savings of 90 staff by April 1982 expected from the abolition of the Register of Business Names; but the Lord President is inclined to feel that this would be preferable to adding to the already serious overloading of the legislative timetable.

If the Bill is to be introduced this Session, as the Secretary of State for Trade proposes, we shall need to move very quickly, and, with your agreement, I intend to raise the matter with colleagues under Parliamentary Affairs at tomorrow's Cabinet.

I am copying this minute to other members of the Cabinet, to the Attorney General, the Chief Whips of both Houses, to Sir Henry Rowe, and to Sir Robert Armstrong.



F.P.

28th January 1981

JU

Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

28 January 1981

Clive Whitmore Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Dear Clive

COMPANIES BILL

My Secretary of State is unable to attend Cabinet tomorrow but he understands that there will be discussion of the Chancellor of the Duchy of Lancaster's minute of today about the Companies Bill and in particular the inclusion of provisions on the purchase by companies of their own shares.

2 My Secretary of State has asked me to say that, had he been present, he would have argued strongly in support of the Trade Secretary's proposal that the Companies Bill should be introduced this session and that it should include provisions on the purchase by companies of their own shares. He well understands the difficulties being experienced by the business managers but he thinks the question important. The purchase by companies of their own shares would particularly benefit investment in small firms by helping outside investors to take short term holdings. The proposal has been endorsed by the Ministerial Committee on Government Strategy (MISC 14), it has been welcomed by many commentators, Ministers are publicly committed to the idea and the proposed provision is short. Omission of the provision from the Companies Bill would be resented by the small firms lobby and would expose the Government to avoidable criticism.

3 I am copying this letter to the Private Secretaries to all members of the Cabinet, to Murdo Maclean (Chief Whip) and David Wright.

Yours sincerely

Ian Ellison

I K C ELLISON
Private Secretary

CONFIDENTIAL

PRIME MINISTER

PARLIAMENTARY AFFAIRS, 29 JANUARY: THE COMPANIES BILL

We are to discuss the Companies Bill again at Cabinet tomorrow. It is ready for introduction and Cabinet accepted last week that it should remain in the programme. Nevertheless at Legislation Committee this morning concern was expressed by the business managers in the House of Lords that the Bill would occupy too much time during the Session. (It is common ground that it would be for introduction in the Lords.)

The Bill is necessary to achieve my staff savings target for 1 April 1982; implements an EC Directive on company accounts; and includes other useful company law provisions. My intention was to table at Committee Stage in the first House further clauses enabling companies to purchase their own shares, and tightening up the law on the disclosure of interests in shares. The Lords business managers are particularly concerned about these additions.

The Chancellor of the Duchy of Lancaster has accepted that no significant reductions can sensibly be made in the scope of the Bill - the scope of debate and of amendments on Companies Bills is not confined to what the Government itself tables. The choice is therefore between a full Bill this session or deferment, for introduction at the beginning of next Session.

In my view, deferment would not merely put back the particular staff-savings covered by the present Bill. It could also jeopardise the much larger savings (570) in my Department for

which I shall need an Insolvency Bill in the next Session. Both these measures will be unpopular. I am reasonably confident of carrying through the companies registration savings as part of a balanced Bill this Session. I have considerable doubts whether we could get both through next Session; to attempt to do so would cause immense problems of Parliamentary and political handling. It would also mean that I should need cover to defer some of my staff savings beyond 1 April 1982.

Of the provisions to come, purchase of own shares fulfils an important small firms policy objective and will be widely welcomed by industry and commerce. It is uncontroversial. Policy approval was given before Christmas and we have announced the intention to legislate. Dropping these provisions would be damaging politically.

Disclosure of interests in shares falls in a different category. Action is expected in the light of episodes such as the surreptitious acquisition by de Beers of a large holding in Consolidated Gold Fields. If we do not table our own proposals the Opposition (and probably our own backbenchers) can be expected to do so. I was about to seek policy approval for what I proposed. I would however be willing to drop the idea of volunteering Government clauses if it is thought that this would contribute to the smooth passage of the Bill.

I can understand the concern of the business managers at the prospect of a long Companies Bill. But I do not think the parliamentary management problem it will pose will reflect its

length - much of it is technical. In the long run, deferment or truncation could be counter productive.

I am copying this letter to other members of the Cabinet, the Chief Whip and Sir Robert Armstrong.

WJB

J. B.

Department of Trade
1 Victoria Street
London SW1H OET

28. January 1981

Ind PM.

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

Mike Pattison Esq
Private Secretary
10 Downing Street
London, SW1

30 June 1980

Dear Mike,

PURCHASE OF OWN SHARES

My Secretary of State sent to colleagues on 6 May a draft text of the consultative document on the purchase by a company of its own shares. I now attach an administrative copy of the Green Paper, which my Secretary of State will be presenting to the Press at a conference tomorrow.

I am copying this letter to the Private Secretaries to the Members of E Committee and to David Wright (Cabinet Office).

Yours ever,

Nicholas McInnes

N McInnes
Private Secretary

JO B

Ind Pol.

10 DOWNING STREET

From the Private Secretary

30 June 1980

Industrial Structure

The Prime Minister has read your letter of 26 June, and the draft speech attached to it which your Secretary of State intends to deliver tomorrow. Subject to the points raised by the Minister of State at the Treasury, as set out in Roy Warden's letter of 27 June, the Prime Minister is content with the draft.

I am copying this letter to Martin Hall (HM Treasury), Ian Ellison (Industry), Murdo Maclean (Chief Whip's Office), Petra Laidlaw (Chancellor of the Duchy's Office), Richard Prescott (Paymaster General's Office) and David Wright (Cabinet Office).

T. P. LANKESTER

Nicholas McInnes, Esq.,
Department of Trade.

Ind Pol

Treasury Chambers, Parliament Street, SW1P 3AG

N McInnes Esq
Private Secretary to Secretary of State
Department of Trade
1 Victoria Street
LONDON
SW1H OET

27 June, 1980

Dear Nick

INDUSTRIAL STRUCTURE

Thank you for sending Martin Hall a copy of your letter of 26 June to Mike Pattison, enclosing a copy of a draft speech for your Secretary of State to make next Tuesday, when he publishes his Green Paper on the Government's proposals to enable companies to purchase their own shares.

The reference in page 7 to the proposals in the current Finance Bill is not quite right. In particular, it is of the essence of the current proposals that they provide (on certain conditions) for a company to distribute to its shareholders the shares in a subsidiary trading company - but not to distribute other assets. The distribution of other assets is something that we shall consider as part of the next stage of this exercise. Mr Rees suggests that this passage could perhaps be revised on the following lines:

> ".... and indeed the Finance Bill Committee are debating today a Government New Clause and Schedule, which represent a significant step towards a more neutral tax policy, as between mergers and demergers. The objective is to enable 2 or more traders, now grouped together under a single company umbrella, to be split up and pursue their own separate ways under independent management. For this purpose, and subject to certain conditions designed to prevent tax avoidance, a trading company will (for example) be able to distribute direct to its shareholders the shares in one or more of its trading subsidiaries".

I am sending copies of this letter to Mike Pattison (No 10), Ian Ellison (Industry), Murdo Maclean (Chief Whip's Office), Petra Laidlaw (Chancellor of the Duchy's Office), Richard Prescott (Paymaster General's Office) and to David Wright (Cabinet Office).

Yours ever,
Roy Warden

R WARDEN
Private Secretary

27 JUN 1980

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

Prime Minister
The attached draft speech, and the proposed Green Paper, seem sensible. Subject to one small point, the Treasury are content.
Shall I say that you are?
M
27/6

Mike Pattison Esq
Private Secretary
10 Downing Street
London, SW1

26 June 1980

A difficult speech to deliver!

Dear Mike,

INDUSTRIAL STRUCTURE

As you are aware, my Secretary of State intends to publish next Tuesday a Green Paper setting out the Department's proposals to allow companies to purchase their own shares. You will recall that my Secretary of State circulated copies of a draft of this Green Paper to all members of E Committee under cover of his letter of 6 May to the Chancellor. As he noted then, he attaches the highest priority, both economically and politically, to legislating on this matter in the Companies Bill in the next Session.

My Secretary of State considers that the publication of the Green Paper will provide him with an opportunity to deliver a wider speech about the underlying structure of economic activity in this country; its implications for economic performance and the Government's policies which affect it. I attach a copy of the speech he proposes to make.

Apart from the question of demergers, the other main theme of the speech is the Government's attitude towards mergers policy. In recent months there has been much speculation about this since it became clear that we have no plans at present to legislate further in this area. The speech will therefore provide a useful opportunity for clarifying this policy.

I am copying this letter to Martin Hall (Treasury), Ian Ellison (Industry), Murdo Maclean (Chief Whip's Office), Petra Laidlaw (Chancellor of the Duchy's Office), Richard Prescott (Paymaster General's Office) and to David Wright (Cabinet Office).

Yours ever,

Nicholas McInnes

N McINNES
Private Secretary

26 JUN 1980

DRAFT SPEECH BY THE SECRETARY OF STATE FOR TRADE

I want to talk today about the underlying structure of economic activity in this country; its implications for economic performance and the Government policies which affect it.

In choosing this theme I am assuming that structure has a bearing on performance. I am not suggesting of course that structure is the major influence on performance, or that by manipulating industrial organisation we shall solve all our problems. On the contrary, I am sure there is no magic solution of this kind, and I suspect that too many of our problems have arisen from a belief in simple solutions to deep seated social and economic issues. But there is certainly a body of opinion which holds that the underlying pattern of economic organisation is an important factor in performance.

Those who know something of the Government's economic beliefs and outlook may be wondering why I should think any of this is my business. Surely the pattern of economic organisation is for the market to decide? What have Government Ministers got to do with it? Well, I certainly do believe in the market system. But, the decisions of enterprises are to some extent shaped by public discussion and the climate of opinion, and I think that a Minister with economic responsibilities should enter into such public discussion.

There is a more practical reason; structure is influenced and sometimes determined by Government policies and legislation. The system of corporate taxation is an obvious example. Company law - one of my own particular responsibilities - is another. And for years Governments here and in other countries have found it necessary to intervene to prevent restraint of competition; the competition legislation - another of my own responsibilities - is also relevant to structure, and one of its objects is to ensure that competitive markets are kept competitive and allowed to operate freely. So whether we like it or not the Government is involved in these questions.

But are we really able to say that industrial structure has an influence on important aspects of performance such as innovation and efficiency? Many have thought so. For many it has been an article of faith that a concentration of production into a few large-scale enterprises is vital in a modern industrial economy. Others argue that large scale organisation - especially combined with monopoly - leads to bureaucracy and inefficiency.

I would be reluctant to make any sweeping generalisations on these lines. All I will say is that if we see the market as the means of guiding economic activity and development, it is plausible that the structure of the market will have some effect on the course of events. Factors such as the number of new enterprises, the relationship between enterprises in different sectors, and the ease of entry into new activities or of transferring resources from one activity to another, all seem likely to be significant. At the very least, one might expect

structural rigidities to have a retarding influence on the speed of development, and in an internationally competitive environment the speed of development in a particular country may affect not only the length of its journey but also its destination.

So much for generalisations. What about the facts of our own experience? Here I am venturing into a minefield. The statistics in this area are scanty and difficult to interpret. On many points the conclusions can only be negative or agnostic, but even an agnostic conclusion can have implications for policy.

First, then, I want to consider the question of industrial concentration. There are various measures of concentration, but the basic idea is to measure the proportion of sales or output accounted for by the largest firms in an economy. Concentration may be measured in a particular market, or in the economy as a whole; in the latter case it is often known as aggregate concentration. There is no doubt that production in the United Kingdom has become much more concentrated since the war, both in total and in separate product areas. It is also generally agreed that the share of the largest firms has increased more than the share of the largest individual factories or plants. Firm size has grown more through an increase in the number of plants owned than by an increase in the size of those plants; so it has not arisen solely from economies of scale in production- though I realise that there are other benefits from size to be taken into account. Moreover

firms have grown as much by mergers and acquisitions as by internally generated expansion.

The significance of all this is difficult to assess. Are we, for instance, more concentrated than our competitors? The production statistics suggest that we are, but allowance has to be made for the great increase in competition from imports, and it can be argued that, due in part to the concentration and efficiency of our distribution system, we are more open to imports than our competitors. Firm conclusions are therefore difficult. But we do not seem to be <u>less</u> concentrated than other countries, and that the onus of proof is on those who would argue that we shall become more competitive simply by becoming <u>more</u> concentrated.

Another point is that compared to other countries of similar size, like France and West Germany, we have a relatively high level of <u>aggregate</u> concentration, which means we have more <u>very large</u> firms, and in particular we have more large firms with a diversified, conglomerate product range.

Lest I be thought to be concentrating unduly on manufacturing industry, I should say that we also appear to have high levels of concentration in such activities as retail distribution.

Finally, on the other side of the coin, it appears that the <u>small firm</u> sector of manufacturing industry is smaller in the United Kingdom than in many other countries. We have an

enormous number of small firms, but their combined share of total employment appears to be relatively low. There are suggestions that the rate of generation of new businesses is disappointing, especially in some important sectors of manufacturing.

The picture emerging is of an economy dominated by large units. Should we draw any conclusions from this? It would be easy to generalise and say simply either that "biggest is best" or that "small is beautiful". But even the very tentative points I have made permit us to draw some important conclusions. One is that it is questionable whether the growth of industrial concentration has simply been the inevitable result of economies of scale. Secondly, it is a cause for concern that compared with other countries our small firms sector appears to be relatively small in size. Innovative small firms are our seed-corn for the future; are we sowing enough? Thirdly, the level of aggregate concentration in the United Kingdom does seem high, which is another way of saying that a high proportion of our industry is concentrated in relatively few, often conglomerate, enterprises. I shall say more later about the special issues raised by conglomerates. At the moment I will just suggest that if economic progress involves a process of natural selection among alternatives, it is important that there should be enough alternatives.

May I then consider some of the implications of these points for Government policy. I emphasised that in areas like company law and taxation the Government is bound to be involved in questions of business organisation. Hitherto the main concern of policy has been to allow firms to organise on a large scale if they wish. Our company law is therefore extremely flexible in allowing companies to be established, to acquire subsidiaries, to expand their area of activities, and so on. Taxation law also has been adapted to allow groups of companies to manage their tax affairs on a concerted basis, for instance by spreading losses. But while we have done everything we can to enable firms to expand, diversify, or join together, we have been less concerned with the possibility that firms, having expanded, might wish to divide into independent smaller uints. Surely the least we can do is to ensure that there are no unnecessary legal obstacles to re-organisation of this kind. To use the current jargon, we must facilitate 'demergers'.

One obvious motive for a demerger would be to reverse the effects of an unsuccessful merger. I, for one, accept that many of the mergers that took place in the 1960s and early 1970s have not fulfilled the hopes of those who promoted them. There are no doubt many reasons why that should be so - the difficulties of fusing two different companies may have been underestimated, and concern over organisational questions may have diverted management from other tasks. The result has been mergers where size has not been accompanied by the improved efficiency anticipated. In such cases it would clearly be desirable for companies to have the option of reverting to separate

management if they wish. But I should emphasise that in talking of demergers I am not thinking just of rectifying unsuccessful mergers, but of removing unnecessary obstacles to splitting wherever that makes sound commercial sense.

The Government is already taking steps to remove obstacles to demergers. In his Budget speech the Chancellor announced that legislation would be introduced to remove possible tax penalties which may have deterred demergers in the past and indeed the Finance Committee are debating today a series of amendments which represent a first step towards a more neutral tax policy towards the distribution of assets or shares to shareholders. The approach chosen, involving a clearance procedure to overcome tax avoidance, involves a useful first step to enable the distribution of assets in specie to existing shareholders - giving them a more direct interest in subsidiary activities within a trading group.

In my own sphere of responsibility, I am publishing today a consultative document proposing an amendment of company law to enable companies in certain circumstances to buy their own shares. Until now this has not generally been permitted in the United Kingdom, although in other countries such purchases are allowed, subject to safeguards against abuse, and appear to operate satisfactorily. The arguments for such a change in the United Kingdom are two-fold.

For private companies, enabling such companies to purchase their own shares would make investment and participation in

them more attractive in a number of significant ways. Entrepreneurs considering putting their own money into an enterprise would feel that it would be that much easier to realise all or part of their investment in the future. Other prospective shareholders would feel that the danger of their being locked in to the company through the narrowness of the market in the shares had been much diminished. Existing shareholders would be less wary of attracting new equity investment since they would regard themselves as less likely to lose control of the business. For all these reasons, a liberalisation of the law is likely to encourage expansion, risk-taking and venture capitalism in the firms which I have described earlier as our seed-corn for the future.

Different considerations apply to companies whose shares are dealt with on a market. Public companies with surplus cash resources (which may perhaps result from the disposal of part of the business) could find it useful to be able to buy their own shares and thus return surplus resources to shareholders, thereby removing the pressure on such companies to employ those surplus resources in uneconomic ways. Thus, the change proposed would increase flexibility of organisation, facilitate the establishment and maintenance of independent private companies, and encourage the better use of available investment resources. Following the useful start with the new amendments in Committee today for demergers we must see if it is possible to devise tax proposals which, while providing safeguards against tax abuses nevertheless enable increased opportunities for the use of purchase of own shares as a constructive means of encouraging

small company capital formation and flexibility of structure as well as the distribution of surplus cash beyond the requirements of a company.

Having said something about demergers and greater flexibility in industrial structure I would now like to turn to the Government's policy towards mergers. That policy, concerning itself with structure, is of course only one side of a competition policy: we also have measures to deal with behaviour - restrictive agreements, anti-competitive behaviour and the exploitation of monopoly power, the primary concerns of the monopolies and restrictive practices legislation. The two approaches are interdependent. To the extent that an effective merger policy helps to maintain a vigorous small and medium-sized firm sector in the economy and restrains the process of concentration, the need for measures to deal with the use of monopoly power will be diminished. Conversely, effective control of anti-competitive behaviour may remove some of the obstacles confronting small firms trying to gain a foothold in the market. This is one of the important aims of our recent Competition Act, which provides a means of dealing effectively and swiftly with such practices as the imposition by a dominant firm of terms and conditions which weight the scales against new competitors. I hope that small firms will not hesitate to take advantage of this new protection by approaching the Office of Fair Trading.

However, today I want to concentrate on mergers, because the publication of the Green Paper on monopolies and mergers policy

in 1978 raised questions which call for an answer. In mergers policy there have been demands for greater predictability of how the Government will regard mergers. I sympathise, and indeed we do try where possible to advise firms who approach us about the likely treatment of mergers that they have in mind. In what I say today I will try to throw some light on our intended approach to mergers and the main guiding principles. But there can be no hard and fast rules. The difficult cases have unique features, unforeseen in any rules, and Governments must leave themselves flexibility to weigh up all the factors. Decisions call for political judgment, and full certainty and precision in merger policy is a will o'the wisp.

Let me remind you on mergers first of the main features of our present arrangements. Under the Fair Trading Act 1973, the Director General of Fair Trading has a duty to keep himself informed - in the language of the Act - of all merger situations qualifying for possible reference to the Monopolies and Mergers Commission (MMC). That means transactions involving the transfer of gross assets of at least £15m or that create or enhance a monopoly share of the market (ie a 25% share). Whenever a qualifying merger is proposed or is found to have taken place, the Director General of Fair Trading, after detailed discussions between members of his Office and the firms involved, makes a recommendation to me on the question of reference to the MMC. If I believe that the merger concerned raises issues of sufficient public interest, I refer it to the Commission for a full investigation. The decision, then as to whether a merger should be investigated by the Commission (MMC)

is mine, although I certainly would not expect to depart from the advice of the Director General unless there seemed to me to be overriding considerations to the contrary. Once a reference has been made, the MMC must normally report within a maximum period of six months. If the MMC finds that the merger situation operates or may be expected to operate against the public interest - and I would ask you to note carefully that only an adverse finding gives me the power to take further action - I may make an order to prevent the merger (or to require divestment if it has already taken place) or, as is much more usual, secure the same results by obtaining undertakings from the parties concerned.

Such a regime for merger control can hardly be called burdensome. In the first place the limits defining referable mergers are set sufficiently high to ensure that only the more important mergers come into the net. The figures tell their own story. Since 1955, when merger control was first introduced, there have probably been about 12,000 mergers among publicly quoted companies. The overwhelming majority of these fall outside the legislation. There have however been about 2,000 referable mergers (excluding newspaper mergers) and of these only 55 have been referred to the MMC. We are talking, therefore, of a mere handful of references, ie 3 or 4 cases a year - although the number has been rising in the past year . Nor does reference in itself mean that I have taken a view against a merger, merely that I believe that there are matters needing fuller study than can be given in the short time available to the OFT in making its recommendation to me. Thus in the 55 references

which have been made since 1955, the MMC has found 18 to be against the public interest, 20 were not found by the MMC to be against the public interest and 17 were abandoned before the MMC reported. Thus of all referable mergers less than 1% failed to satisfy the MMC.

Earlier this year I decided to raise the criterion for possible references based on the value of assets from £5m to £15m, thus excluding many smaller mergers from consideration altogether. This was a substantial increase in the threshold at one step but even after taking this decision I have given much thought to the possibility of a further increase. There is after all no automatic connection between the value of assets acquired and the significance of a merger for competition. But I have decided to keep the threshold at £15m for the time being. One important reason for this decision is that to raise the threshold further would make it most difficult to control the piecemeal acquisition of small firms by a much larger firm which however falls short of a 25% market share. At the same time I would be much less concerned about mergers between two firms both of which were of relatively small size - below say /£25m?7 - and I would not normally consider such a case suitable for reference unless there was a demonstrable restriction of competition or other special circumstances.

In practice, then, very few mergers have been held up for full investigation. The policy has operated against the background of the prevailing belief in the 60s and early 70s that extensive mergers were necessary to improve industrial

efficiency. Extensive mergers duly took place, but there has been widespread scepticism about their results. Studies by economists have nearly all shown that on average the results of mergers are disappointing. Of course this is not conclusive, but so far as I know no-one has actually claimed that the evidence is favourable to mergers. Insofar as the legislation and its application have reflected a generally favourable presumption, it therefore seems desirable to re-appraise the policy.

Such a re-appraisal was carried out by an official working party set up by the previous Government under the Chairmanship of Mr Hans Liesner, the Chief Economic Adviser to my Department. Their report on monopolies and mergers policy was published in 1978 as a Green Paper, generally know as the Liesner Report. The Liesner Report suggested changes in both policy and legislation on mergers. The approach towards mergers in general would be neutral, rather than favourable as it had tended to be in the past. There would be a two-stage process in the assessment of mergers. First, there would be an assessment of the effects of the merger on competition. If these were not significant, that would be an end of the matter. But if they were adverse to competition, then some positive benefits of the merger would have to be demonstrated if it were to go ahead. This two stage procedure would be laid down in legislation for the Monopolies and Mergers Commission to follow, and detailed non-statutory guidelines would be published indicating the criteria the Government would follow in making references to the Commission. This procedure was expected to result in a significant increase in the number of references.

Since taking over responsibility for merger policy I have naturally given much thought to these proposals. I have considered the various comments people have made, and of course I have tested the theoretical views on the subject against my own experience of dealing with merger cases. I have not been convinced that there would be any real advantage in the relatively precise and formal procedures proposed in the Green Paper. Let me therefore put an end to uncertainty by saying that I have decided against new legislation on mergers for the time being. The present law may not be ideal in every detail, but it is understood and offers sufficient flexibility to accommodate any shifts of emphasis that may be needed . I see everything to be said for continuity and nothing to be said for constantly changing the rules.

But a decision not to change the legislation is not an end to the matter. I do believe it is necessary to take account of our experience over the last fifteen years or so. This calls for a distinctly more sceptical approach by all of us in assessing the pros and cons of prospective mergers. In saying 'all of us', I mean in the first place those in industry who make the initial assessment of the case for a merger; if they bring more realistic assessment to bear, it may be that some ideas for mergers will not reach first base, as some in the past should not have done.

Nevertheless, for the foreseeable future one must expect there to continue to be a small proportion of merger cases which raise serious issues for the public interest and which cannot simply be left to the parties and the shareholders to decide. I expect the competition authorities to look at such cases first and foremost from the point of view of whether the merger would be detrimental to the maintenance or promotion of effective competition. If it would, then we would have to pay careful attention to the other benefits and disbenefits which would be likely to arise for the economy. And in the light of experience one would be bound to take a hard and sceptical look at any suggestion that a merger would automatically lead to rationalisation, economies of scale, or other miraculous transformations.

This is not a novel policy. I see it as a reaffirmation of the policy embodied in the 1973 Act, which laid down new public interest criteria for both monopoly and merger inquiries and, for the first time, placed the main emphasis on maintaining and promoting competition between suppliers. It underlined the importance of competition as a stimulus to innovation and cost reduction. Though it may not be a panacea, I am sure this emphasis on competition as a safeguard for the public interest is right, and I want to re-emphasise it as the proper basis for applying merger control.

Competition must of course be considered in a broad and practical sense, as indeed the legislation recognises in talking about

effective competition. We are not talking about hypothetical perfect competition, or about mathematical calculation of market shares. The overall and long-term effects of a merger must be considered, on both actual and potential competition. In general we must look very carefully at any mergers which eliminate direct competitors in a market, or which may distort competition through linking supplier with customer. There is no simple rule, though. In some circumstances such a merger could be positively beneficial to effective competition, by enabling smaller suppliers to combine to compete more effectively with larger ones. On the other hand, a merger could be detrimental even if it involved no direct reduction in competition, since its effect might be to eliminate a promising source of future competition or to shelter some activities from market disciplines.

This leads me to the question of so-called 'conglomerate' or diversifying mergers, which on the narrowest view might seem to have few implications for competition. There is nothing sinister in conglomeracy as such: large companies may see their own best interests in diversifying, and that can bring wider benefit, for example by the introduction of new management resources from a large group into an ailing company. But the acquisition of a successful company by a large and unrelated company which is merely shopping around when flush with funds - in an attempt to increase its earnings per share and hence its share price - may in reality involve a diminution of competition and no evident efficiency gain, and a careful assessment by the MMC - difficult though that is - could be necessary. It is

impossible to generalise about such cases. It may be that a successful specialist company would benefit from being taken over by a major diversifying company, for example because funds would be available for investment in R and D or for expansion. Equally, however, the elimination of independent decision centres; or the possibility of the imposition of inappropriate or bureaucratic management styles; or the capacity to use greater financial muscle for cross-subsidisation and possible predatory pricing which distorts the market process and conceals the true competitive position; even when not accompanied by direct reduction of competition these could be factors raising doubts about possible detriments which call for an objective appraisal.

However, we live in a world in which change is rapid and international boundaries increasingly irrelevant to economic activity. Both these facts have implications for competition policy: rapid change means that what applies in one case or at one time may not apply in another. Internationalisation means that markets have to be defined in European or even world terms: acquisition of United Kingdom firms by overseas companies may in some circumstances lead to sharper competition in the domestic market; United Kingdom firms may be able to compete in export markets only if they acquire interests in overseas companies. None of this I see as inconsistent with a vigorous competition policy, which is what its title implies - a policy above all to promote competition. A Government policy towards mergers which throws the competition issues into sharper relief should not, at least in the longer run, lead to

significantly more references, but should ensure that the reasons for an individual reference are more clearly understood; it may also lead the MMC to shift the balance slightly in the number of mergers which they find to operate or to be likely to operate against the public interest. It will, I hope, increase the number of instances in which mergers are better thought out by the parties concerned before they are embarked upon. My overriding concern is that our policy should strengthen the competitive environment in which United Kingdom industry operates and provide that essential spur to improved efficiency on which our prosperity depends.

The time has come - you may think it is overdue - to summarise what I have said. If I have to put it in a single formula, it is that the structure of our industry should be flexible enough to respond to the changing needs of the market. Innovative new firms - many of which will be relatively small - are a vital part of this response. We should also be able to adapt our existing organisations rapidly to new needs, and this includes being able to break structures down into smaller units - and if necessary to recombine them. And, while mergers will continue often to be a beneficial response to change, we must guard against those whose effect is mainly to stifle market forces, and against the needless accumulation of ever larger and more unwieldy concentrations of power and control. In these ways we can help to encourage a structure within which enterprise can more easily flourish.

Ind Pol.

2 MARSHAM STREET
LONDON SW1P 3EB

My ref: H/PSO/13824/80

Your ref:

30 May 1980

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3/5

Dear John

PURCHASE OF OWN SHARES

Thank you for sending me your draft Consultative Document. It raises important issues, which need a full and proper public airing. I, therefore, welcome your proposal to issue it soon.

A copy of this goes to other members of E Committee and to Sir Robert Armstrong.

Yours ever

Michael

MICHAEL HESELTINE

The Rt Hon John Nott MP

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
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Secretary of State for Industry

16 May 1980

The Rt Hon John Nott MP
Secretary of State for Trade
Department of Trade
1 Victoria Street
London SW1

R 20/5

Dear John,

PURCHASE OF OWN SHARES

Thank you for sending me a copy of your letter of 6 May to Geoffrey Howe, together with a copy of the draft consultative document.

I welcome the proposals in the document which should significantly benefit many small companies. As you note, significant tax questions remain unresolved and I echo your hope that the Treasury will give further sympathetic consideration to a liberalisation of tax law.

Copies go to members of E Committee and Sir Robert Armstrong.

Ever,

Keith

19 MAY 1980

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London, SW1

6 May 1980

Dear Geoffrey

PURCHASE OF OWN SHARES

In the context of measures to encourage small businesses and enterprise generally I have been examining the provisions of the Companies Acts that (with certain exceptions) prohibit a company from purchasing its own shares. We have said publicly on a number of occasions that the Government were looking into this with a view to relaxing the present prohibition, and that we would undertake consultations with a view to legislating in the next Companies Bill in the 1980/81 Session.

The Queen's Speech and Future Legislation Committee (QL) decided last week to recommend to the Cabinet that a Companies Bill should be introduced before the end of the year, and the Committee agreed that, subject to the necessary policy approval, the Bill could include legislation on the purchase of own shares.

There has been increasing public interest in this aspect of company law in recent years, particularly in the small business sector, and it was referred to in the Interim Report on the Financing of Small Firms (Cmnd 7503) of the Committee to Review the functioning of Financial Institutions. But the debate so far has been unfocussed and very general. Before we can reach our own decisions, and translate them into legislation, we need to consult widely on both the major policy

From the Secretary of State

issues and detailed aspects of the possible ways of proceeding.

I therefore propose to issue a consultative document on this subject and attach a draft text which I intend to publish in early June. (Whether this will be in the form of a Green Paper or of a document issued by my Department I have not yet decided.)

I do not propose to summarise the draft in this letter. I would however emphasise that I attach the highest priority, both economically and politically, to legislating on this matter in the next Companies Bill. The scope and details of that legislation can be decided in the light of the response to the consultative document. The arguments for a change in the law with regard to private businesses are overwhelming. I personally also believe there are very strong arguments for enabling public companies to purchase their own shares - in effect a form of demerging.

As you will see, the bulk of the draft comprises a paper by my Research Adviser on company law, Professor Gower, the eminent authority on company law. In finalising his text Professor Gower has benefitted from discussion of earlier drafts by my Advisory Panel on Company Law, which contains distinguished representatives of the legal and accountancy professions as well as of business interests. This should be borne in mind when any amendments to the text are being considered.

Apart from the company law aspects, there are significant tax questions at issue, as the consultative document makes clear. I very much hope that the Treasury's further consideration of this subject will open the way to a more favourable tax regime for the purchase of own shares as a complement to any liberalisation of the company law regime.

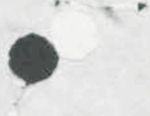
From the Secretary of State

I am copying this letter to members of E Committee and to Sir Robert Armstrong. In view of the need to issue the consultative document as soon as possible, I would be grateful for any comments by 16 May.

Yours ever

John.

JOHN NOTT



THE PURCHASE BY A COMPANY OF ITS OWN SHARES

A CONSULTATIVE DOCUMENT

PART I

INTRODUCTION

1. Broadly speaking company law in the United Kingdom does not permit a limited company to buy its own shares. The main reasons for this have been that such purchases could reduce the capital of the company available for the protection of those who deal with the company and to prevent companies "trafficking" in their shares. However, many other countries permit such purchases and increasing interest has been shown in this country in replacing the present general prohibition with provisions which, whilst providing for the maintenance of the company's capital, would also give companies the opportunity to buy their own shares, to the benefit both of companies and of shareholders.

2. During the Parliamentary debates on the Bill which became the Companies Act 1980, Mr Reginald Eyre, Parliamentary Under Secretary of State, Department of Trade, announced that the Government attached high priority to relaxing the present prohibition and that consultations would be undertaken with a view to bringing forward necessary legislation as part of a Companies Bill which it was hoped to introduce in the 1980/81 Session of Parliament.

3. The purpose of this consultative document is to seek views on the extent to which it is desirable to change company law to enable companies to buy their own shares and on the form that these changes and the consequent safeguards should take. In Part II of this document, Professor L C B Gower, the Research Adviser on Company Law to the Department of Trade, discusses the present law in this country, compares it with the law in other countries, and describes and analyses various ways in which the law could be amended. Part II represents Professor Gower's personal views and not those of the Government: it is published both as a major contribution to the consideration of the issues involved, and as an analytical framework for consultation on this subject. In preparing Part II Professor Gower has had the benefit of the advice of the Advisory Panel on Company Law, established by the Government in February 1980.

4. The Government attaches particular importance to the principal economic arguments in favour of a relaxation of the present law. For private companies, a change should make investment and participation in such companies more attractive, by providing shareholders with a further means of disposing of their shares and by permitting the remaining members to maintain control and ownership of the business. Different considerations apply to companies whose shares are dealt in

on a market. Public companies with surplus cash resources could find it useful to be able to buy their own shares and thus return surplus resources to shareholders, thereby removing the pressure on such companies to employ those surplus resources in uneconomic ways, and enabling shareholders to deploy the resources to better effect.

5. Any changes in the law would need to be accompanied by safeguards for the interests of creditors, shareholders and others interested in the company, who could otherwise be prejudiced if the company was able freely to reduce its capital.

6. So far as public companies are concerned, any relaxations in the law would also have to be consistent with the provisions of the EEC Second Directive on company law. The Companies Act 1980 implemented this Directive, which amongst other matters was concerned with the maintenance of the share capital of public companies. The Directive lays down certain minimum safeguards which must be met if Member States permit public companies to purchase their own shares; the directive does not, however, require Member States to permit such purchases, (this matter is discussed in more detail in Part II).

7. In advance of the present consideration of possible changes in the law, the Companies Act 1980 restates in statute, with certain minor modifications, the prohibition, established by judicial precedent in the nineteenth century, on companies buying their own shares. However, during the passage of that legislation the Government made it clear that this statutory restatement was without prejudice to the further consideration of the whole area.

8. The proposal that companies should be permitted in defined circumstances to buy their own shares will open up one somewhat separate issue. The development in the UK of unit trust schemes, through which investors can spread their investment in equities, is largely the consequence of the rule that a company cannot buy its shares. This has precluded the development of "open-ended" investment trusts of the type which operate in other countries. The question posed in this paper will therefore raise two further questions: first, whether it would be advantageous to permit the development of open-ended investment trust companies in the UK, and secondly whether special statutory safeguards would be required for investors in such companies, bearing in mind the provisions in the Prevention of Fraud (Investments) Act for the protection of investors in unit trusts.

/TAX - PASSAGE UNDER DISCUSSION WITH REVENUE/

The Government invites comments on the issues raised in this consultative document, in particular on:

i) the strength of the case in principle for a change in the law to enable (a) private companies and (b) public companies, to purchase their own shares;

ii) the safeguards for members, creditors, employees and other interested parties that should be attached to any provisions enabling (a) private and (b) public companies to purchase their own shares;

iii) whether, if private companies were permitted to purchase their own shares, this should be in defined circumstances only (eg on the death or retirement of a member);

iv) whether for private companies, the present requirements for the formal reduction of share capital should be eased, to permit simpler and cheaper reductions;

v) whether, in the case of public companies, any power to repurchase should be restricted eg to unlisted shares or to companies of a defined size;

vi) whether if repurchase of own shares were permitted, it should be stipulated that such shares should be cancelled, rather than treated as "treasury shares";

vii) whether the Companies Acts should be amended to permit companies to issue redeemable equity shares;

viii) whether private companies operating employee share schemes otherwise than through trustees should be permitted to buy their own shares, and to finance such schemes as a further exception to the general prohibition in section 54 of the Companies Act 1948.

ix) the implications of according to investment companies a power to repurchase their shares.

It is suggested that Professor Gower's analysis in Part II would provide a convenient framework for observations on these points.

Representations on the issues raised in this Consultative Document should be sent to

Department of Trade
Companies Division
Room 509
Sanctuary Buildings
16-20 Great Smith Street
London
SW1P 3DB

and should reach the Department by 30 September 1980.

PART II

PURCHASE OF OWN SHARES

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PURCHASE BY A COMPANY OF ITS OWN SHARES

THE PRESENT POSITION

1 It was established by the case of Trevor v Whitworth (1887) 12 App Cas 409, H.L. that a limited company may not buy its own shares because this would amount to an unauthorised reduction of capital. This basic principle has now been codified in the Companies Act 1980 and applied to any acquisition by a limited company of its own shares "whether by purchase, subscription or otherwise": S. 35(1). Certain exceptions are recognised. A Company limited by shares may acquire its fully paid shares otherwise than for valuable consideration and any company may acquire its own shares "in a reduction of capital duly made": S. 35(2). Companies may also redeem redeemable preference shares, purchase shares in pursuance of an order of the Court under Section 11 or 75 of the 1980 Act or 5 of the 1948 Act and may forfeit shares or accept a surrender in lieu for non-payment of calls: S. 35(4). Where partly-paid shares are acquired by a nominee of the company, Section 36 of the 1980 Act makes the nominee personally liable and, by Section 37, where any shares of a public company are acquired by it or its nominee they must be disposed of or cancelled within a prescribed time and, in the meantime, cannot be voted. Further, a public company is, in general, prohibited from taking a charge over its own shares: S. 38.

2 The rule that a company may not buy its own shares does not apply to an unlimited company. But prohibitions have been extended to other transactions which, though technically they do not reduce capital, are thought to be subject to equal or greater objections. Thus, in general, a subsidiary company may not become a member of its holding company (Companies Act 1948, S. 27) nor may a company provide financial assistance for the purchase or subscription of its shares or those of its holding company (ibid S. 54) - and these two sections apply equally to unlimited companies.

3 Of the exceptions listed in paragraph 1 to the general principle, that relating to redeemable preference shares is by far the most important and also the most interesting in the present context. It shows that it is possible to provide for the re-purchase of shares in a way which does not impair capital to the detriment of creditors. Under Section 58 of the Companies Act 1948, replacing the provision of the 1929 Act which first legitimated the issue of such shares by registered companies, a company if so authorised by its articles may issue preference shares which are, or at the option of the company are liable, to be redeemed. But they may be redeemed only if fully paid, and only out of profits which would otherwise be available for dividend or out of the proceeds of a fresh issue made for the purpose of the redemption. In either event, any premium payable on redemption must be provided for out of profits (and, under the amendment in the 1980 Act expressly "profits which would otherwise be available for dividend") or out of the share premium account. Moreover if redeemed out of profits an amount equivalent to the nominal amount of the shares redeemed must be transferred to an undistributable reserve, rather unhappily named "the capital redemption reserve fund" unless and until it is subsequently converted to share capital on an issue of bonus shares. In other words, capital is not reduced[1] but is replaced and maintained either by the new share capital or by the capital redemption reserve fund. Hence, insofar as capital is a protection to creditors against depletion of the company's resources by subsequent distributions (and under the dividend

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1 But see paragraph 22, below

rules introduced by Part III of the 1980 Act the protection will become substantial in the case of public companies) that protection is not impaired.

4 The main reason for restricting the power to issue redeemable shares to preference shares was, no doubt, that the possibilities of abuse are less in this case since they do not normally afford voting control of the company or fluctuate in value to the same extent as equity shares. But since there is no definition of "preference shares" for the purpose of Section 58 it would appear to cover any which afford a preference either as regards dividends or capital. Hence it 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 (and, indeed, of the votes). If the section is intended to limit redeemable shares to non-equity shares it has achieved its purpose only because advantage has not in practice been taken of it in relation to equity shares. The only worthwhile purpose that the word "preference" seems to serve is that it ensures that the company has other, non-redeemable, shares and therefore helps to avoid the complications which occur when a company finds itself without any shareholders.

[ ]

5 So much for the present position in the United Kingdom. In the USA the common law developed differently and it was held in most States that a company could buy back its own shares so long as it did so out of profits and without impairing capital. The practice is now regulated by statute in most States and is generally permitted subject to various limitations and conditions.[2] A distinction is drawn between shares issued as redeemable,

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2 And is now spreading to other common law countries: see, for example, Canada Business Corporations Act 1974-75, S. 32

which is generally impermissible in the case of common stock, and shares not liable to be redeemed and cancelled but which can be re-purchased by the company, becoming "treasury shares" until resold. The latter is permitted in the case of all types of share, including common stock, but, again, subject to limitations and condition. While the shares are held in the company's treasury they are not entitled to dividends or votes.

6 Similarly in the other EEC countries companies were generally permitted to repurchase their shares, though the practice now is normally regulated by statutes which are in process of amendment to comply with the provisions of the Second EEC Directive on Company Law referred to in paragraph 7 below. The conditions under which the practice was permitted differed widely. In Germany, for example, the amount of share capital that a public company (Aktiengesellschaft) could re-purchase was normally limited to 10% and the acquisitions had to be for certain specified reasons. One of these was "if the acquisition is necessary to avert serious damage to the company" - a formula (reflected in art. 19.2 of the Second Directive) which was treated as justifying use of the power pretty freely. In France the provisions were more complicated and restrictive. Purchases were allowed for the purposes of (a) cancellation on a resolution to reduce capital, (b) employee share schemes, and, (c) in the case of listed companies, maintaining the quoted price of the shares or to facilitate mergers. But acquisitions were subject to various conditions and the total acquired under (b) and (c) could not exceed 10% of the shares of any class. In the Netherlands, on the other hand, the provisions were few and normally fully paid shares could be acquired up to 50% of the share capital. As in the USA, the general position was that the company could not exercise or enjoy any rights in respect of the shares held by it. Generally speaking too (though the reverse was true in Denmark) greater freedom was permitted

in the case of the types of company corresponding to our private companies. The position in the other EEC countries also differed from that in the UK in that capital could be reduced with less formality so long as the minimum capital requirements (a long-established feature of European company laws) were not infringed. And France recognised the (to us) strange concept of "reimbursed shares" (actions de jouissance) under which the shareholder had his proprietary interest redeemed but remained a member of the company in other aspects.

7 One of the objects of the Second EEC Directive on Company Law is to harmonise the provisions relating to purchase and redemption of shares. The more important of the relevant articles are set out in Appendix A to this Paper. As will be seen, they are lengthy and complicated but their general effect can be summarised by saying that they forbid the purchase or redemption of shares except that, to accommodate to some extent the divergent practices of the various Member States, they permit their laws to allow purchases, withdrawals and redemption of shares subject to compliance with certain conditions which are generally more stringent than those hitherto prevailing in the Continental systems. The Directive, which we have implemented by the 1980 Act, permits us to maintain the existing exceptions to the Trevor v Whitworth rule but does not require us to extend them. It would, however, allow us to widen these exceptions subject, in the case of public limited companies, to laying down stringent conditions. The Directive does not apply to our private companies (though the 1980 Act has extended some of its provisions to them) and so far as they are concerned we are free to widen the exceptions to any extent we wish.

8 The main conditions which would normally have to be present if public limited companies were to be permitted to purchase their shares are:

(a) the shares must be fully paid

(b) authorisation must be given by the general meeting,

(c) the total acquired and held must not exceed 10%,

(d) the effect of the purchase must not be to reduce the net assets below the amount of the subscribed capital plus undistributable reserves,

(e) voting rights must be suspended so long as the shares are held by the company, and

(f) purchases and the reasons for them must be set out in the "annual" report.

Somewhat different conditions are laid down in respect of redeemable or withdrawable shares; articles 35-37 being designed to accommodate the various Continental practices (art. 35 relating to the French actions de jouissance referred to above) and art. 39 to accommodate the UK practice. It will be noted that this article does not prescribe that the redeemable shares must be preference shares.

THE CASE FOR CONSIDERING EXTENSION OF THE POWER TO ACQUIRE THE COMPANY'S SHARES

9 Until recently there has been little public interest in the possibility of a further extension of the power for a company to acquire its own shares. The Jenkins Committee, having taken evidence from America that "the power enjoyed by companies in the United States has not led to abuse and is useful for a number of purposes" (Cmnd 1749 of 1962, para 167) nevertheless reported as follows:

"168. In our view, if the Companies Act were amended to give a limited company a general power to buy its own shares it would be necessary to introduce stringent safeguards to protect both creditors and shareholders. We think it would be possible to devise effective safeguards and we do not think they need to be unduly complicated. On the other hand, we have received no evidence that British companies need this power and 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. The power might occasionally be useful when a minority of the members of a small company whose shares were not readily marketable wished to retire from the company and the other members were unable or unwilling to buy their shares at a fair price; we doubt if such a power would often be exercised for this purpose since it would usually give rise to a surtax assessment in respect of past profits of the company still undistributed and, in cases where tax difficulties can be overcome, a quasi-purchase of the shares of the company can be, and in practice is, carried out by the machinery of a reduction of capital by repaying those shares at a premium. We have therefore reached the conclusion that there is no justification for the general abrogation of the familiar rule that a limited company may not buy its own shares; indeed, we think that the rule should be expressly stated in the Act.

169. We have considered whether a special exception should be provided for companies which operate profit-sharing schemes involving the issue of shares to their employees. The value of such shares will to a great extent depend upon their being freely marketable. The employee, if the shares are not quoted or if his holding is small,

may find it difficult to sell them. In such circumstances, it is argued, the company should be empowered to provide a market in the shares. We received no evidence that this problem presented insuperable difficulties and on the evidence presented to us we do not think that the proposed exception would be justified. For the same reason, we do not accept the suggestion that Section 27, which prohibits a subsidiary from acquiring shares in its holding company, should be modified in favour of profit-sharing companies."

In other words an extension was rejected not on the ground that it would be unduly difficult or lead to abuse but rather on the ground that nearly everybody was happy with the status quo.

10 This attitude has continued to prevail until very recently when there has been some pressure for a wider power. For example, the Committee under the Chairmanship of Sir Harold Wilson which is reviewing the working of the City's Financial Institutions, has in an Interim Report on The Financing of Small Firms (Cmnd 7503 of 1979) advocated that consideration should be given to permitting such firms to issue redeemable equity shares as a means of enabling them to raise needed capital without parting permanently with family control: page 12, para 17. The Association of Independent Businesses, in a well-argued Memorandum to the Department of Trade, has pointed out that a shareholder needing to sell all or part of his equity in a small unlisted company may be unable to find a buyer other, perhaps, than a financial institution or public company and that this is one of the factors leading to excessive concentration of industry and commerce. The Association argues that if a company were permitted to buy its own shares a greater number of unlisted independent companies would be able to continue in separate existence and that additional investment in

them would be encouraged. Others have suggested that larger companies with surplus liquid assets might more usefully employ them in informal reductions of capital by buying up their shares rather than by looking round for outlets for further diversification.

11. The main advantages which have been claimed for allowing companies to buy their own shares are the following:

(a) It may enable the company to buy out a dissident shareholder.

(b) It facilitates the retention of family control.

(c) It provides a means whereby a shareholder, or the estate of a deceased shareholder, in a company whose shares are not listed can find a buyer.

(d) It is particularly useful in relation to employee share schemes in enabling the shares of employees to be repurchased on their ceasing to be employed by the company.

(e) It may help with the marketing of shares by enabling the company to give a subscriber an option to re-sell to the company.

(f) It enables companies to purchase their shares for use later in stock option plans or acquisition programmes, or to increase their earnings per share and thereby make the remaining shares a more attractive investment.

(g) If redeemable shares are quoted at below the redemption price it enables the company to save money by buying up in advance of the redemption date (a practice which our Companies can, and do, adopt in the case of debentures but cannot in the case of redeemable preference shares).

(h) It permits the evolution of the open-ended investment company or mutual fund instead of having to operate through the device of a unit trust.

(i) It provides a company with surplus cash with a further means of using it advantageously.

(j) It can be used to support the market for the shares if this is thought to be unduly depressed, thus preserving for the shareholders the value of their shares as marketable securities.

(k) If the company not only buys its shares but trades in the treasury shares thus acquired it may make money thereby.

12. It is not suggested that all the above advantages are necessarily desirabl (j), in particular, may be regarded as objectionable as leading to market-rigging and (k), trafficking in its own shares, is not self-evidently a desirable corporate activity. But some - particularly (b), (c) and (d) clearly are valuable, especially in the case of closely-held companies and it is in relation to such companies that the power is mainly used in the USA. Even in these cases, however, the power is clearly capable of abuse; for example by enabling the management to maintain its own control or to gain control and to use the company's money in doing so.

13. Some of the objectives of the transactions listed in paragraph 11 above, can already be achieved by other means. It is common, for example, for the articles of association of private companies to provide that a member wishing to dispose of his shares will first offer them to the other shareholder, or to the directors. Thereby the objectives of (b) and (c) may be achieved. But they will not be achieved if the other members are unable or unwilling to buy. And, if the right of first refusal is coupled with an absolute discretion to the directors to refuse to register transfers (as it almost invariably is) the shareholder, or the estate of the deceased shareholder, may be locked in the company with little prospect of receiving dividends (since profits will probably be re-invested or distributed as directors' remuneration) or may ultimately be forced to sell to the members or directors at a gross undervalue. One of the main reasons for the enactment of section 210 of the 1948 Act (now replaced by Section 75 of the 1980 Act)

was to provide some remedy for this.

Moreover if, as is sometimes the case, the articles provide that the offer shall be to the directors (as opposed to all the members) it provides a ready means whereby directors, in breach of the spirit, but not the letter, of their fiduciary duties, can maintain and enhance their control of the company. These possibilities of abuse would be reduced if the company itself could be the purchaser. And clearly there would be many cases where the other members would be happy for the company to buy although they were unable to raise the money to do so themselves. They might well be unable to raise the necessary money themselves by borrowing on the security of their shares because shares in private companies are not an attractive security to outside sources of finance and the company itself is precluded by section 54 of the 1948 Act from lending for the purpose of enabling its shares to be acquired.[3]

14. Similarly, it is possible to institute employee share schemes whereby employees are enabled or obliged to re-sell on leaving employment. But this has to be done by operating the scheme through trustees, although, thanks to the exceptions to section 54, the needful finance can be provided by the company.[4] This necessity to establish a trust is not a serious snag in the case of large public companies. But those running small private ones undoubtedly regard it as an unnecessary and incomprehensible complication which is a serious disincentive to the establishment of such schemes.

15. For these reasons there is a case for consideration, at least, of an extension of the power of a private company to repurchase its own shares. If, however, an extension is to be of practical value perhaps the most serious problem that will have to be solved is one of tax law rather than

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3. S.38 of the 1980 Act, generally prohibiting a company from taking a charge on its own shares, applies only to public companies.

4. But, as a result of an amendment made by the 1980 Act, in the case of public companies only, out of profits available for dividend: 1980 Act Schd 3, para 10.

company law. It was, indeed, the tax implications that led the Jenkins Committee to conclude that a power to buy their own shares would be of little value to private companies. The tax position has changed substantially in recent years and will alter radically when the proposals relating to "close companies" announced in the 1980 Budget Speech are enacted. In the case of trading companies the Revenue's present power to apportion undistributed income (above certain limits) among the participators, taxing them at their personal rates will be abolished, thereby making it easier for such companies to accumulate profits out of which their shares could be re-purchased. But a major problem will remain - and this applies equally to non-close companies - the shareholders whose shares are to be re-purchased will not be willing to sell unless any profit they make is liable only to capital gains tax and not treated as income. Yet if this is conceded there is a possibility of using the power as a tax avoidance device by extracting income in the form of capital.

It is understood that the present practice of the Revenue when shares are re-purchased by an unlimited company is to treat any part of the purchase price in excess of the capital paid up on the shares as taxable income of the seller. Moreover, if the shares are re-purchased out of the company's profits the company is deemed to have made a"distribution" with consequent liability forthwith to pay advanced corporation tax. If this practice were maintained a sale to the company, rather than to a third party, would be highly disadvantageous to the selling shareholder and detrimental to the company itself unless it was liable to full corporation tax payable almost immediately. Nevertheless if it is thought desirable in the interests of small businesses to permit them to buy their own shares the needed changes in company law should precede, and not wait upon, changes in tax law and practice which will not be made in respect of transactions which are legally impossible.

16. The case for an extension in relation to public companies is of a different character. Advantages (a) to (d) are either of no or of lesser moment, (e) seems undesirable in the case of listed securities and (j) and (k) are probably actually or potentially objectionable. The only seemingly unobjectionable advantages appear to be (f) to (i). It is, however, doubtful how far use would be made of (f), (h) or (i). If public companies want to have shares available for stock options or acquisitions they seem to experience no difficulty in persuading their members to authorise the creation of further share capital for this purpose. If they want to reduce, rather than increase, capital they can do so under a formal reduction scheme which, in the case of larger companies, is a relatively simple and inexpensive operation. The argument that, if companies could spend surplus cash on informal reductions by buying their shares, they would do so rather than engage in possibly dangerous expansion and diversification seems distinctly dubious in view of the many surveys which have concluded that the main motivation of company managements is a desire to expand their empires. It is difficult to see how a power to purchase the company's own shares could be directly used to facilitate "de-mergers". At the most it might provide an outlet for surplus cash alternative to further take-overs and, when a company had hived-off part of its undertaking by a sale, provide it with an alternative method of distributing the proceeds of sale to its shareholders. As for (h) (the possibility of operating through Mutual Fund companies rather than Unit Trusts) at the time of the Jenkins Committee the unit trust industry showed a marked lack of interest and enthusiasm for any such innovation. If this is still the view of the industry there seems little point in introducing a possibility of which use is unlikely to be made.

17. The tax problems adverted to in paragraph 15, above, would arise equally in relation to public companies. While the present tax law and practice remains, using a power to re-purchase shares would normally be

disadvantageous both to the shareholders and the company whether the purchases were a means of distributing surplus cash, rather than paying increased dividends over a number of years, or a means of providing a market for shareholders wishing to sell. But, as with private companies, if it is thought that the power is needed, company law should be amended to confer the power without waiting for changes of tax law.

THE EXTENSIONS WORTHY OF CONSIDERATION

18. In deciding what extensions are worthy of consideration and subject to what conditions, the following assumptions are made:

a. That there should be no breach of our international obligations under the EEC Second and Fourth Directives;

b. That, even in the case of private companies to which the Second Directive need not be applied, we should not substantially reduce the additional protection afforded to creditors and members by the stricter rules embodied in the 1980 Act in respect of authorisation of issues of further capital, raising and maintaining capital, distributions to shareholders, and pre-emptive rights.

19. Even within the constraints imposed by these assumptions, the possible extensions are many, but it is thought that those set out below are those worthy of serious consideration. They are set out from the narrowest possible to the widest with, in each case, a summary of the problems involved and the suggested solutions and the conditions which might need to be imposed. Possible extensions in relation to private companies are dealt with first. In this connection what is meant by "private companies" is private companies which are not, at the time when the shares are re-purchased, subsidiaries of public companies. If the view is taken that extensions should not be made in relation to public companies it seems clear that their subsidiaries should be treated in the same way.

PRIVATE COMPANIES

POSSIBILITY A

Expressly permit private companies to issue redeemable equity shares

20. This would meet one particular point raised by the Wilson Committee: see paragraph 10 above. And it could be simply achieved; essentially all that would be necessary would be to delete the word "preference" from section 58 of the 1948 Act. As a matter of strict law this would achieve little. As pointed out in paragraph 4 above, that section already permits the issue of redeemable equity shares so long as they confer some preferential rights in respect of dividends or capital repayment. Nevertheless, there seems no reason why it should not be done and the section is misleading as at present worded.

21. Two other amendments would, however, be desirable. The first, a minor one, would be designed to ensure that the company, as a result of redemptions, did not end up without any members. The 1948 Act provides two sanctions when a company continues to trade with fewer than the prescribed minimum number of members - as a result of the 1980 Act, two in respect of both public and private companies. Section 31, as amended by the 1980 Act, makes the remaining members personally liable for the company's debts contracting while they know it is so trading. This is totally ineffective if there are no remaining members. The other sanction is liability to be wound up under section 222(d). But if the company was solvent it is unlikely that anyone would petition to wind it up. It is suggested therefore that section 58 should be amended to provide that the power to issue redeemable shares should not be exercised unless the company has another class of (irredeemable) shares.

22. The other desirable amendment is of greater importance. Anomalously, section 58 at present permits a premium payable on redemption to be provided

either out of profits or out of the share premium account (as docs s.56(2)) and the capital redemption reserve fund which has to be established consists only of "a sum equal to the nominal amount of the shares redeemed". The result is that "capital", in the sense of share capital plus share premium account need not be fully maintained on redemption. If 1,000 redeemable preference shares of £1 each are issued at £1.10, share capital plus share premium account will equal £1,100. If later the shares are redeemed at £1.20 out of profits and the share premium account all that will replace the £1,100 is a capital redemption reserve fund of £1,000. This anomaly may not matter much in the case of preference shares in the strict sense, where the premiums are likely to be small. But in relation to redeemable equity shares the premiums might well be many times the nominal value, resulting in a substantial reduction of capital on redemption. It is therefore suggested that sections 56 and 58 should be amended so as to prevent redeemable shares from being redeemed otherwise than out of profits or an issue of new capital without any use of share premium account which would be left intact.

23. The point raised in the previous paragraph regarding redemption premiums draws attention to a difficulty that would arise in relation to the redemption of equity shares, that of finding a formula which will ensure that the amount repaid in redemption fairly represents the security's stake in the equity at that date. It can be done (approximately) in the case of listed securities by the use of the so-called "Spens formula" whereby the redemption price is based on recent quotations. In the case of unlisted securities in private companies the nearest approach would be to adopt the formula common when other shareholders are given pre-emptive rights, ie "at a fair price to be determined in default of agreement by the auditors of the company"-a formula which can (and has) produced widely different answers since the valuation of shares in private companies is notoriously difficult.

24. While this Possibility seems unobjectionable, it is not what private companies really seek. Their lack is not the ability to issue equity securities expressly created as redeemable, but the ability to buy out members or the estates of deceased members (ie Possibility C below).

POSSIBILITY B

Permit private companies to buy shares issued under an employees share scheme

25. Having regard to the present state of our law it is difficult to see what objections there could be to this further extension other than purely doctrinal ones. The exceptions to section 54[5] of the 1948 Act already permit "the provision by a company, in accordance with an employee share scheme ..... of money for the purchase of, or subscription for, fully paid shares in the company or its holding company .... " Under this, companies can, and do, finance such schemes and the shares can be issued to employees and re-purchased out of the finance provided by the company. In the case of private companies[6] this can be done without the finance having to be provided out of profits. At present it can be done only by vesting the shares in trustees, a complication which, as pointed out in paragraph 14 above, is a disincentive to the establishment of such schemes by small companies.

26. It is therefore suggested for consideration that proviso (b) to section 54(1) should be amended in relation to private companies (other than subsidiaries of public ones) by deleting the requirement that the purchase or subscription must be by trustees and that a further exception should be added to the prohibition on purchasing or subscribing by the company of its own shares (section 35 of the 1980 Act), namely the acquisition by a company of

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5. As amended by 1980 Act, Schd 3, para 10.

6. But, as a result of the 1980 Act, not public companies

fully-paid shares included in an employee share scheme. In addition an amendment would be necessary to section 27 of the 1948 Act permitting a similar exception to the rule that a company must not become a member of its holding company.

27. If this were done the only other provisions which would appear to be desirable are:

(a) that as in the case of redeemed shares they should on re-purchase be cancelled[7] and replaced by a capital redemption reserve fund;

(b) that the company should not repurchase employee shares unless, thereafter, it will still be in a position to pay its debts as they fall due.

28. Provision (a) would alter the position which now obtains when employee shares are vested in trustees. Where, as is commonly the case, the trustees are closely allied to the management this can be used as a means of enchancing their own control. This danger would be increased if votes could be exercised on shares vested in the company, for then it would be the management which would control the exercise of the votes. Cancellation would avoid this danger and also solve the problems which may arise if a solvent company goes into liquidation while employee shares are held by the trustees - even if this possibility has been foreseen and provided for, it may give rise to unexpected tax and other consequences[8]. As regards provision (b), it would clearly be improper for a company to provide further finance to a trustee-operated scheme if the result would be to make it insolvent in the sense that it could not pay its debts as they fall due. The same should apply if the company itself were permitted to operate a scheme.

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7. But with power to issue a like amount without liability to further capital duty: see para 37.

8. See Rutter v Charles Sharpe & Co Ltd/1979/I W.L.R. 1429

29. Hence from a purely company law standpoint, this extension could be achieved very simply. Present tax legislation, however, restricts the use likely to be made of it. In most cases the company will probably wish to set up the scheme so that the employees receive the tax concessions conferred on "approved profit sharing schemes" under Chapter III of the Finance Act 1978[9] Employee share schemes can secure approval under the present terms of that Act only when shares are initially vested in trustees and retained by them subject to various restrictions for a prescribed period or until earlier cessation of employment by reason of redundancy, death, injury, or disability or reaching pensionable age. It would be possible to achieve the same result by instead making it a condition of approval that the shares should be of a separate class which would be subject to similar restrictions. But even if the Revenue regarded it as essential to maintain the need for trustees for these approved schemes it does not follow that the suggested extension would not be worthwhile. Companies may still wish to operateemployee share schemes which are free from the restrictive conditions laid down for approved profit sharing schemes - but which may nevertheless confer tax advantages on the employees under section 79 of the Finance Act 1972. To force them to set up trusts in such circumstances seems pointless.

POSSIBILITY C

Additionally[10] permit private companies to repurchase their shares

30. If practicable, this solution would confer on private companies all the advantages which are sought by them. It would, however, raise greater problems than Possibility A or B. Before discussing these, however, it is necessary to consider whether, in fact, private companies would find it

9. The 1980 Budget Speech announced further concessions in respect of such schemes.

10. It would, of course, be possible to adopt this in lieu of B which would then, to some extent, be subsumed within C but it is thought that it would be preferable to treat employee shares separately.

possible, in the light of the tax law and the need to maintain the capital of limited companies, to take advantage of the power.

i. <u>Practicability</u>

31. It would clearly be wrong to allow companies to redeem shares not expressly issued as redeemable with safeguards against reducing capital to the detriment of creditors less stringent than those applicable to redeemable preference shares. Assuming therefore that the safeguards in section 58 are not reduced (a question discussed below in paragraphs 50-55) it follows that shares could not be repurchased unless -

(a) they were fully paid,

(b) they were repurchased out of the proceeds of a fresh issue or out of profits, and

(c) if purchased out of profits, the share-capital which they represent was replaced by an undistributable reserve - the capital redemption reserve fund.

It can be argued that these rules - or rather (b) and its corollary (c) - would in practice prevent private companies from exercising the power since they rarely accumulate sufficient profits to buy out in one lump sum a member who has, say, one-quarter or more of the equity.

32. However, one of the reasons why they do not accumulate profits - the power of the Revenue to apportion short-falls in distributions by close companies - will, as pointed out in paragraph 15, above, be removed in the case of trading companies when the 1980 Budget proposals are enacted. And partnership firms commonly buy the shares of a deceased or retired partner by instalments out of future years' profits. If this was permissible in the case of companies (and there seems to be no reason why not) the lack of accumulated profits would be unimportant. If partnership firms (which are

treated just as strictly for tax purposes) find it practicable to buy partners out[11] it would seem to be equally practicable for private companies (most of which are incorporated partnerships) to do likewise if they were allowed to. The only difference would be that whereas unincorporated partnerships (or unlimited companies) can use capital as well as profits, limited companies could not.

33. Doubtless therefore there would be some cases where, without resort to capital, it would not be possible for a private company to buy out a major shareholder, even if the price were paid by instalments. But the mere fact that private companies would not always be able to use the power to repurchase is not a reason for refusing to confer the power for use in those cases where it would be practicable to do so.

34. There is, however, a further tax problem which would have to be solved if the power was to be of practical value. The shareholder or his personal representatives will not wish to sell to the company unless the net price after tax is as much as it would be if the sale was to a third party. In other words he or they will want any profit to be taxed as a capital gain only and not as income. But, if this were conceded in all cases where a company buys its shares, it would afford an easy way of extracting income in the form of capital. A company instead of distributing its profits by way of dividend or directors' salaries could instead carry out a pro-rata informal reduction of capital by repurchasing a proportion of each member's shares. Clearly this would, and should, be treated as payment of dividend. In the USA, where tax questions have been one of the major problems arising from the power to buy shares, the Internal Revenue tries to distinguish between those transactions which are in reality distributions of dividends and those which are bona fide purchases. A distribution to a shareholder in a complete

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11. Though it is now less common for large payments to be made for the share of goodwill.

redemption of his holding is treated as a sale or exchange. Proportionate redemptions from all shareholders are treated as dividends. For transactions in between, the basic principle is that a purchase by a company of its own shares is treated as a dividend unless it is established in the particular circumstances of each case that it is not essentially equivalent to one. In principle this seems to be sound but it affords a greater measure of uncertainty and administrative discretion than might be regarded as acceptable in this country. However, so long as it was conceded that a purchase of the whole of a member's shares would be treated as a sale, giving rise only to such tax liability as would arise on a sale to a third party, the main need would be met. Without this concession the position of the retiring shareholder would be even worse than it is at present, for the directors, if they had absolute power to refuse transfers, would probably say "The company is prepared to buy your shares at a fair price but not to permit a transfer to an outsider". Without more evidence of badfaith their decision could hardly be attacked. Yet the effect would be that the price payable by the only available purchaser would be unfairly disadvantageous to the seller.

35. Another problem would be the determination of what is a fair price. In the absence of any other provision in the company's articles this would depend on free bargaining between the company and the shareholder and the purchase would not take place unless both were satisfied. Many private companies would doubtless insert in their articles a provision that if any shareholder wished to dispose of his shares the company would be entitled to buy them at a fair price to be determined in default of agreement by the company's auditor. But as already pointed out (paragraph 23, above) the subjective judgment of the auditor would not necessarily ensure that the price was objectively correct. It has to be faced that there is no cast-iron way of ensuring that the price paid is not excessive (thus reducing the

value of the remaining shares) or (what is more likely because of the restricted market and the probably unfettered discretion to refuse transfers) too small (thus increasing the value of the remaining shares). Safeguards against these dangers and against the danger that purchases will be used by the directors to enhance their own control or otherwise unfairly, are discussed in paragraphs 41-48 below and can, it is thought, be provided.

36 It seems, therefore, that there are no insuperable difficulties and that, subject to some further relaxation of the tax rules, the power would be useful sufficiently often to make it worthwhile.

ii. Questions arising

37. The first question is to decide whether shares repurchased should be cancelled or whether they should be treated as "treasury shares" which the company could re-sell. In relation to private companies it seems clear that there is no case for courting the accounting and other problems which dealings in treasury shares would involve. Shares purchased should be cancelled but there should be the same concessions relating to capital duty as apply to issues of further capital following redemption of redeemable shares (see Companies Act 1948 Section 58(4) as amended by Finance Act 1973, sched. 19, para 14). This, in effect, would enable the company to bring in a new shareholder in place of the one bought out without payment of further duty. It would also preserve the protection to the members afforded by Sections 14 and 17 of the 1980 Act.

38. If companies were permitted to buy their own shares it would follow, in the absence of express prohibition, that they could enter into executory contracts, or obtain options, to do so. There seems to be no grounds for

prohibition; indeed for reasons stated in paragraph 32, executory contracts appear to be vital if the aim is to be achieved. Performance of such contracts would necessarily be conditional on its being lawful for the company to pay for the shares at the time when the contract is completed, ie on the assumption that payment could lawfully be made out of profits only, on the company's having profits available at the time or times of performance. What should happen, however, if the contract has been partly performed? Suppose, for example, that the company has 900 issued shares owned equally by three shareholders. One dies and the company agrees to buy his 300 shares for £30,000, payable by equal instalments out of the profits for the next 3 years. The first year's payment is made but in the second year insufficient profits are available. If this eventuality has been foreseen and dealt with in the contract all may be well. But what if it has not? It is tempting to say that the purchase of the first 100 shares for £10,000 should be completed butthat the contract should be cancelled as regards the balance. But that would be to make a different contract for the parties and, probably, one that would not be satisfactory to either. The estate wants to get out of the company and not to be left with 200 (probably unsaleable) shares. The company has agreed the price on the basis that it is buying a holding which, through the power to block a special resolution, conferred a measure of negative control. An alternative solution (though clearly not one wholly satisfactory to the estate) would be to say that in the absence of agreement to the contrary the whole transaction should be cancelled. This might occasionally present difficulties if the personal representatives had distributed the £10,000 or if the 100 shares had already been transferred to the company and cancelled. Neither solution is ideal. But all that seems to be necessary is to provide some rule which, in the absence of express agreement, would provide a workable solution if not a perfect one.

iii. Safeguards

39. As with issues of redeemable shares, companies should be permitted to repurchase their shares only if authorised by their articles. But this alone would not provide adequate publicity. If companies were permitted to enter into executory contracts or to obtain options to buy their shares it would be necessary to ensure that publicity was given to the fact that the shares were subject to the contract or option. When shares are issued as redeemable this is ensured because the articles have to state the terms and manner of redemption and because the relevant share certificates will describe them as redeemable. In such cases the right or obligation to redeem will be an incident of the shares and will run with them into the hands of any holder. This would not be so in the case of other types of share.[12] The contract or option to buy would be personal to the shareholder and a purchaser, without notice, from him would obtain a good title but for the fact that if the directors have power to refuse transfers, as in practice they will, they would obviously refuse to register him. Hence he ought to be able to find out that the shares are under contract or option; and so should anyone dealing with the company - especially anyone minded to become a shareholder - for the contract may materially affect the true net worth of the company. Provision would obviously need to be made requiring notice to be given to the Companies Registry whenever a company acquired any of its own shares. But in addition it is suggested that whenever it entered into a contract or acquired an option to do so it should also give such notice. It is also suggested that the company should be required to maintain at its registered office a register (analogous to the register of directors'

12 It would be possible to provide that a note of the contract or option should be endorsed on the relative share certificates but it is doubtful if this would be much of a safeguard.

holdings and dealings required under Section 29 of the 1967 Act) of all acquisitions, contracts, or options which would show, inter alia, the price paid, and that the register (and perhaps copies of the contracts themselves?) should be available for inspection at least by any member or debenture holder. This would be a valuable additional protection against improper or improvident behaviour by the directors and would help to some extent in the determination of a fair price since it would be possible to obtain details of any past purchases. Unless, in the case of private companies, it would be thought an undue invasion of privacy any member of the public might be permitted to inspect these documents and any member or debenture holder to inspect the contracts themselves.

40. Some minor amendments to Schedule 8 of the Companies Act 1948 would also be necessary to ensure that the annual accounts gave adequate particulars of shares repurchased. When a company had entered into a contract to acquire shares, paras 11(5) and 12(1)(d) should be made applicable. The EEC Fourth Directive (which applies to private as well as public companies) requires separate details to be given of holdings of the company's own shares, but only "to the extent that national law permits their being shown in the balance sheet" as assets. If the foregoing suggestions were adopted they would clearly not be so shown since they would have been cancelled.

41. The final question is whether the present law would provide adequate safeguards against the undoubted opportunities for abuse that an extension of the power to repurchase shares would provide. Purchases could be used to enhance the directors' control or to increase the value of their shares using the company's money to do so. If made in advance of a likely take-over bid they could be highly prejudicial to the holders of the shares bought.

Since the company would rarely be in a position to buy out every member if a number wished to sell within a short period, it could be used to favour one member rather than another. These abuses can take place at present - except that the directors or other "insiders" have to use their own money when they buy and not that of the company. The power to use the company's money might increase the likelihood of these abuses and introduce others since, as already pointed out, if the company pays too much for the shares its creditors and remaining members are prejudiced, and if it pays too little its remaining members gain unfairly.

42. In the case of dealings in shares in private companies it is unrealistic to place reliance on the extra-legal restraints imposed by the Codes of Conduct promulgated by The Stock Exchange, and the Council for the Securities Industry or on the City Code on Take-Overs and Mergers. Nor will the new statutory rules regarding insider-dealing have relevance to dealings in shares of private companies. Hence, unless additional protections were provided, the safeguards would consist of (a) the directors' duties of care, skill and good faith and (b) the protection of minorities afforded by a winding-up order on the ground that it is just and equitable or the alternative remedy under the Section 75 of the Companies Act 1980. These rules would provide remedies if the directors were negligent in the exercise of the company's power or used it for an improper purpose or to benefit themselves or if the power was exercised in a way which was unfairly prejudicial to some part of the members. Hence they would go some way to provide the needed safeguards if only shareholders could be relied upon to invoke them. Unfortunately, but understandably in the light of the expense of corporate litigation, this cannot be relied on. Nor would the resources of the Department of Trade be adequate to enable abuses to be effectively prevented or remedied by the exercise of the Secretary of State's powers

to appoint Inspectors and to take legal action in the light of the Inspectors' Reports.

43. It therefore appears that further safeguards are needed. It is accordingly suggested that any contract to repurchase shares should require ratification by the company in general meeting. This would ensure that all shareholders learnt of the proposed repurchase in advance and that they, and not merely the directors, had to pass judgment upon its desirability. If, however, the shareholder who wished to be bought out, had a majority of votes, this alone would not be an adequate safeguard. It would be somewhat more effective if an extraordinary or a special resolution, requiring a three-quarters majority, were prescribed, but, even so, in some cases the affirming resolution would be passed only as a result of the votes of the self-interested shareholder.

44. It is therefore suggested for consideration that on any such affirming resolution the shares which were to be purchased should not be voted. It is appreciated that this would be to introduce into English Company Law a somewhat novel concept since at general meetings, as opposed to directors' meetings, members are generally permitted to vote in their own selfish interests. But in the not-wholly dissimilar situation when the general meeting has been asked to ratify the issue of shares allegedly allotted improperly the court have directed that such shares shall not be voted: Hogg v Cramphorn Ltd. [1967] Ch. 254; Bamford v Bamford [1970] Ch. 212, C.A. Moreover, if it is conceded that what is sought to be achieved is that the power should be exercised only when that is in the interests of the company as a whole and if, as the case-law establishes, that means in the long-term interests of members present and future, it seems logical that the decision should be taken by members who will remain in the company rather than by

those who are seeking to leave it. It should also be borne in mind that where the shares are those of a deceased (or bankrupt) member it would not always be possible for his shares to be voted because his personal representatives (or trustee in bankruptcy) had not been registered as a member (Table A. art. 32).

45. An alternative to the safeguard suggested in the foregoing paragraph would be to allow all members (including the one being bought out) to vote on the resolution but to entitle a dissenting minority to petition the court to set aside the resolution. Experience with other circumstances in which such a safeguard is already provided (for example under Sections 72 and 209 of the 1948 Act) does not suggest that it would be particularly effective in view of the courts' reluctance to interfere with the business judgment of directors and majority shareholders and any safeguard dependent on the willingness to incur the expenses of litigation is better avoided except as a last resort, especially in the case of small companies.

46 Since the new statutory insider dealing rules (1980 Act, Part V) do not apply to transactions in the securities of private companies it would be desirable to provide protection against the increased opportunities for abuse of inside information that would arise if the company itself could buy its shares. It could be argued that since most private companies are essentially incorporated partnerships the transactions should be treated as contracts uberrimae fidei demanding disclosure of all material facts. But since an issue of shares is not a contract uberrimae fidei in the full sense it would be illogical to go so far with a contract to repurchase. It would seem better to draw on the analogy of the provisions of the 1980 Act and to prohibit a repurchase when either the buying company or the selling shareholder (in the case of a private company the latter might have information unknown to the company) had "unpublished price sensitive information"

as defined[13] in Section 73(2) of the Act. But in contrast with the Act's provisions relating to dealings, normally on The Stock Exchange, it is suggested that the sanctions for breach should not be limited to criminal penalties against individuals but that, in addition, the transaction should be voidable at the instance of the innocent party.

47. The foregoing safeguards would not be needed if repurchases were pro-rata from all shareholders. This however is unlikely to occur in the case of private companies without a formal scheme of capital reduction because it seems inconceivable that the Revenue would ever countenance a relaxation of the tax rules treating it as an income distribution - it would provide obvious opportunities for tax avoidance.

48. It is not thought that specific provisions would be needed regulating the insertion in the company's articles of a power to repurchase shares at an arbitrary price. It could not be successfully argued that such a power or its exercise was necessarily effective as "in the interests of the company as a whole" for in this context that does not mean the company as a corporate entity.[14]

iv. <u>A narrower alternative</u>

49. It should be pointed out, in conclusion of the discussion of this Possibility, that instead of conferring power to repurchase in any

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13 The definition might need verbal amendment to make it appropriate to dealings in securities of private companies.

14 <u>Greenhalgh</u> v <u>Arderne Cinemas</u> /1951/ Ch. 286, C.A., at 291

circumstances if profits permitted, private companies might be permitted to do so in defined circumstances only. In that event the circumstances might be:

(a) in redemption of redeemable shares in advance of the redemption date,

(b) repurchase of the whole of a member's holding on his death or his retirement from gainful occupation as a result of disability, redundancy or attainment of pensionable age.

There seems to be a strong case in any event for allowing repurchase in case (a). It might reduce the temptation to redeem under a formal reduction scheme when, because of changes in interest rates, such shares have become detrimental to the company and might enable the shareholders to avoid being redeemed under such schemes on terms which they regard as unfair.[15] Case (b) reflects the type of special circumstances in which it might be conceded that the purchase price should not be treated as an income distribution for tax purposes.[16] But so far as company law is concerned it is

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15 Scottish Insurance Corpn v Wilsons & Clyde Coal Co [1949] A.C. 462, H.L; Prudential Assurance v Chatterly Whitfield Collieries, [1949] A.C. 512, H.L; Re Saltdean Estate Co [1968] 1 W.L.R. 1844. The objections of The Stock Exchange and Institutional investors to premature purchases for cancellation of listed redeemable securities could hardly apply to freely negotiated repurchases of unlisted shares where the alternative of a reduction scheme may operate harshly in the necessary absence of the protection of the Spens formula: see Re Saltdean Estate Co.

16 the conditions for approved profit sharing schemes referred to in paragraph 29, above.

suggested that the power to repurchase, if conferred at all, should be exercisable generally and not restricted to those circumstances in which, for tax reasons, it is most likely to be used. It would, however, be possible to restrict the use of the power to specific types of private companies, for example to "proprietary companies" or to middle-tier private companies as defined in the recent Green Paper, Company Accounting and Disclosure (Cmnd 7654).

CAPITAL MAINTENANCE

50. Before leaving private companies there is one further question which needs to be discussed. As has been pointed out, if redemption or purchase of shares is permitted only out of profits, some private companies will find themselves unable to avail themselves of the power. Is it practicable, without substantially reducing the protection afforded to creditors present and future, to relax the present rules? This could be done in one (or both) of two ways. The first would be to enable private companies to redeem or purchase shares without having to comply with all the present restrictions in section 58; the second could be to make it easier for them to reduce capital and thus to effect a purchase by that route. In considering the feasibility of either it needs to be borne in mind that (a) under-capitalisation is a major cause of failure of private companies, often with grievous loss to their creditors, and (b) the capital maintenance and dividend rules have now been strengthened by the provisions of the 1980 Act. Hence any weakening of the protection is something that needs to be looked at very critically.

51. Under the present Section 58 shares cannot be redeemed

(a) unless they are fully paid,

(b) except out of profits available for dividend or the proceeds of a fresh issue,

and

(c) unless, on redemption out of profits, an undistributable reserve (the capital redemption reserve fund) replaces the nominal amount of the shares redeemed.

52. It has long been accepted that only fully paid shares can be redeemed and it seems clear that a relaxation of (a) could not be contemplated.[17] Uncalled capital, in the rare cases in which it exists, is in reality a valuable asset to which creditors can turn and on which they are entitled to rely. To permit the uncalled liability to be wiped out, except on a formal reduction of capital, seems unthinkable. It has been argued that no harm would be done to creditor protection so long as the uncalled liability was replaced by capital redemption reserve fund. But a reserve is not as effective a protection as an "asset", particularly in relation to private companies to which Section 40 of the 1980 Act does not apply. Similarly there would be a grave weakening of the present protection if a company could buy back shares out of capital. At first sight, however, it might be thought that this could adequately be prevented by maintaining (a) and (b) alone. This, however, is not so, for (c) is, in effect a necessary corollary of (b). This can be illustrated by the following simplified example:

> Company A has issued £10,000 Ordinary Shares and £10,000 Redeemable Preference Shares at par. It has made realised profits of £10,000 and now has net assets of £30,000, represented by £20,000 share capital and £10,000 free

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17 The EEC Second Directive takes the same view: see arts. 19.1.d and 39.b.

reserves. It uses the £10,000 to redeem the Preference Shares. Its share capital is now £10,000 and its net assets £20,000. But for the need to establish a capital redemption reserve fund it would still have free reserves of £10,000 available for dividend, and would, in effect, have redeemed the Preference Shares out of capital.

It seems clear, therefore, that (c), the need to replace the shares redeemed by an undistributable reserve, is vital if creditor protection is not to be substantially reduced, both in the case of redeemable preference shares and re-purchase of shares.

53. The second way of meeting the difficulties of private companies, ie by permitting simpler and cheaper formal reductions of capital, seems more promising. If, however, the need to obtain the approval of the court were maintained it seems doubtful whether the procedure could be simplified and cheapened (even if the jurisdiction of the county court was extended) sufficiently to make it attractive to small private companies. The real protection afforded to creditors and members by the need for court approval is not so much that reduction schemes are liable to be rejected by the court (it is difficult indeed to find cases of such rejection when the formal requirements have been complied with) but rather the fact that the need to go before the court involves the collaboration of barristers, solicitors and accountants who for the sake of their reputations, will not support reduction schemes unless they are satisfied that they are fair and justified. It is their professional charges rather than court fees which account for the expense. But any legal procedure which dispensed with their collaboration would result in a grave weakening of the protection afforded.

54. However, as already pointed out (paragraph 6) we are exceptionally strict in our present requirement that a formal reduction of capital always involves confirmation by the court. It is for consideration whether adequate safeguards to creditors and members could not be secured without involving the court - an involvement which in the case of small companies imposes a heavy burden. In a Report to the Finance and Economics Committee of the States of Jersey[18] the Commercial Relations Department has suggested a procedure which draws on Continental experience and provides pretty stringent safeguards. The relevant clauses of the Draft Bill (article 50(1), relating to redeemable shares and article 51, relating to reductions of capital generally) are set out in Appendix B to this paper. The precise solution recommended would not be practicable here for we have no officer equivalent to the Commercial Relations Officer and the Companies Division of the Department of Trade does not have the resources needed to undertake the task of confirming in place of the court. Nor do our private companies need to have a minimum capital. But is is for consideration whether a modified version of the proposals, on the following lines, would not afford adequate protection.

55. A private company might be permitted to redeem or re-purchase shares out of capital and to reduce capital accordingly, in the following manner:

(a) Passing a special resolution ratifying the redemption or purchase and approving the reduction of capital.

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18 Report on Company Law Reform with Draft Company Law, October 1975

(b) Delivering to the Registrar of Companies a copy of the resolution together with

i a statutory declaration by all the directors certifying that the company was and, after the redemption or purchase, would be able to pay its debts as they fell due and that it had adequate capital facilities for the conduct of its business without resort to the capital employed in the redemption or purchase;

and

ii a report by the company's auditor stating that he had examined the books and accounts of the company and that in his opinion the company would be able to pay its debts as they fell due without regard to the capital resolved to be returned to the shareholders.

(c) The Registrar would cause a notice of the proposed purchase or redemption and reduction of capital to be published in the Gazette and in at least one national newspaper and one local newspaper circulating in the locality where the company had its principal place or places of business.

(d) Unless within a prescribed time from the publication of the notice any creditor or member applied to the court to prohibit the redemption or purchase and reduction the resolution would become effective at the expiration of that time.

(e) If application were made to the court the resolution would not take effect except to the extent that, and subject to such conditions as, the court ordered.

(f) Stringent penalties would be prescribed for statements made without reasonable grounds and if the company were wound up, and proved to be insolvent, within, say 12 months or 3 months after the publication of its next accounts (whichever was the longer) it would be presumed until the contrary was shown that the directors did not have reasonable grounds for their declaration (cf Section 283 of the 1948 Act).[19]

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PUBLIC COMPANIES

PRELIMINARY CONSIDERATIONS

56. In discussing whether public companies and their subsidiaries should be given powers to re-purchase their own shares, five preliminary considerations need to be stressed.

(a) The case for doing so is of a different character from that of private companies: see paragraph 16 above.

(b) In relation to public companies (though not their private subsidiaries) any extension would have to comply with the stringent conditions imposed by the EEC Second Directive: see paragraphs 7 and 8 above and Appendix A.

(c) The EEC Second Directive, art. 39, does not prescribe that redeemable shares must be preference shares.

(d) The present need to operate employee-share schemes through trustees does not impose an excessive burden on public companies

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19 A possible additional safeguard would be to provide that if winding up took place within the prescribed period the shareholders should be liable to return the capital repaid. This, however, would prevent the personal representatives of a deceased shareholder from completing administration of the estate until after the expiration of the period.

and to dispense with trustees and yet comply with the provisions of the Second Directive would make for needless complications.

(e) The EEC Second Directive envisages that companies having power to re-purchase their shares might then re-sell them. This would, in effect, introduce a practice alien to British notions (though common in the USA) namely that of public companies keeping their shares "on tap" indefinitely. In none of the recent discussions on this subject has there been any advocacy of allowing companies to traffic in their shares and if they were empowered to do so it would lead to a number of complicated problems regarding accounting for dealings and the tax treatment of the company in respect of profits or losses on such deals. If, as proposed in the case of private companies, public companies were merely empowered to buy their shares for cancellation, these complications would be avoided, as would some of the constraints which would otherwise be required by the Second Directive.

Having regard to these considerations the only questions that it seems necessary to discuss are whether powers analogous to Possibilities A and C should be extended to public companies (and their private subsidiaries) and, if so, what modifications of the suggestions made in relation to private companies would be desirable, or necessary, in order to comply with the Second Directive.

POSSIBILITY D

Expressly permit public companies and their subsidiaries to issue redeemable equity shares

57. All that has been said about Possibility A in relation to private companies is equally applicable here. In practice the power might prove more useful to public companies since the problem of fixing a meaningful redemption price could be solved in the case of listed shares by the use of the Spens formula: see paragraph 23 above. Whether such shares would prove popular with investors (or The Stock Exchange) is another matter but the fact that they might not is not an adequate reason for not openly recognising what is already legally possible. But in relation to public companies it would be even more desirable to make the amendments to sections 56 and 58 of the 1948 Act suggested in paragraph 22 above[20].

POSSIBILITY E

Permit public companies and their private subsidiaries to re-purchase and cancel their shares

58. The principal advantage of this proposal is thought to be that it would make it easier for companies to "go public" without obtaining a Stock Exchange listing, for the company would provide an alternative market. The expenses of listing and the minimum size of issues that The Stock Exchange will list are undoubtedly grave handicaps in the way of small concerns wishing to market their shares. On the other hand, it can be argued that the initial scrutiny and subsequent vigilance of The Stock Exchange is the most potent protection which investors enjoy, and certainly the track records of many of the (relatively few) companies which have made public issues without a listing do not suggest that such issues should be encouraged. Moreover the proposals of The Stock Exchange to introduce an Unlisted Securities Market (in addition to dealings under the present rule 163(2)) may solve the problems of small public companies in this regard.

20. The present position seems inconsistent with the spirit, if not the letter, of the EEC Second Directive.

59. If, nevertheless, it was thought desirable to adopt this Possibility, much of what has been said in relation to Possibility C is equally applicable here and need not be repeated. The public company would be permitted to re-purchase shares only if authorised by its articles and if the shares were fully paid and only out of profits available for dividends or the proceeds of a fresh issue. On repurchase the shares would be cancelled but with a similar concession to that under section 58(4) as amended (see paragraph 37) on an issue of further capital (to which the provisions of sections 14, 17 and 18 of the 1980 Act would apply). The capital of shares re-purchased out of profits would be replaced by a capital redemption reserve fund - particularly important in the case of public companies in view of section 40 of the 1980 Act. Public companies would not face the same difficulties as private ones in complying with these conditions and it is not suggested that in their case any less formal provisions for reduction of capital should be contemplated. Additional extra-legal protections against abuses would be likely to operate because The Stock Exchange, the C.S.I., and the Take-over Panel would doubtless evolve additional rules to deal with this new situation. Where the shares purchased were listed there would be recent quotations which would help in ensuring that a fair price was paid and if they were bought on The Stock Exchange the new insider dealing rules would operate[21].

60. Certain modifications of the proposals made in relation to Possibility C would however be necessary; for example it would obviously be impracticable to require each individual re-purchase to be ratified in general meeting. Others would be needed to comply with the Second Directive.

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21. Other common-law countries on introducing power for a company to buy its own shares have thought it necessary to provide expressly that the company is then an "insider": see Canada Business Corporations Act 1974-75, s.125(1)(b). Since the rules in our 1980 Act impose liability only on individuals it might be desirable to clarify precisely who would be liable when the purchase was by the company itself.

61. It is accordingly suggested that the power should be exercised as follows:

(a) Authorisation should be given in general meeting and should lapse unless renewed at each succeeding annual general meeting. The authorisation should determine the maximum number of shares of each class that might be re-purchased and the maximum and minimum price which might be paid (thus complying with art.19 1a of the Second Directive).

(b) Notice of all acquisitions, contracts and options should be given to the Registrar of Companies and the company should also be required to maintain a register of all acquisitions, contracts or options which should be open to public inspection (cf paragraph 39 above).

(c) The directors' report or notes to the accounts should state the reasons for acquisitions during the relative accounting period, the number, class and nominal value of the shares acquired, the proportion they represent of the issued share capital at the beginning of that period and the total price paid (thus complying with art.22.2 of the Second Directive).

(d) Shares could be lawfully re-purchased only if fully paid and only out of the proceeds of a fresh issue, or out of profits which, consistently with sections 39-45 of the 1980 Act, the company could have distributed by way of dividend (thus complying with art.19.1c and d of the Second Directive).

(e) Re-purchased shares would be cancelled forthwith and, unless re-purchased out of the proceeds of a fresh issue, replaced by an undistributable reserve.

(f) No re-purchase could be made by a public company if the cancellation of the shares concerned would have the effect of reducing the nominal value of the company's issued share capital below "the authorised minimum"

as defined in section 85 of the 1980 Act (thus complying with art.34 of the Second Directive).

62. Since the shares re-purchased would not be held by the company, but cancelled, no other conditions seem to be necessary in order to comply fully with the Second (or Fourth) EEC Directive. It is for consideration, however, whether, by analogy with art. 19.1b of the Second Directive, some limit (additional to that resulting from paragraph 61(f)) should be imposed on the proportion of the share capital which a company might acquire - art.19.1b prescribes a limit on shares acquired and held of 10%. Since the members in general meeting would have to determine the maximum number which could be acquired (see paragraph 61(a) above) and since creditors would be protected because there would be no reduction of the capital yard-stick (see paragraph 61(d) and (e) above) the case for imposing any such limit does not seem to be strong. The only obvious purpose which it would serve would be to restrict the extent to which re-purchases might be used by the directors to enhance their own control or increase the value of their own shares. That, however, would be achieved only if the limit was a proportion of the shares of each class (as well as of the total subscribed capital) and, further, was a proportion of the capital originally subscribed (a percentage of the currently subscribed capital would allow the capital to be reduced gradually). Having regard to the conditions suggested in paragraph 61 and to the legal and extra-legal restraints on self-dealing it hardly seems necessary to prescribe a limit. The limit resulting from condition (f) in paragraph 61 would operate only in the case of public companies and not in relation to their private subsidiaries. It would therefore provide a means of buying out a minority alternative to a purchase by the parent company. That, however, appears to be unobjectionable.

63. One further article of the Second Directive is relevant, however. Article 42 prescribes that "For the purposes of the implementation of this Directive the laws of the Member States shall ensure equal treatment to all shareholders who are in the same position". The danger that a power to re-purchase might be used to discriminate unfairly as between one shareholder and another has already been adverted to (paragraph 41 above) and doubtless the draftsmen of the Directive had this in mind. Although the risk of such discrimination is probably less in the case of public companies (certainly the larger ones) and is taken care of by the legal and extra-legal constraints to which they are subject, the article may have important implications in the present context. Where the company's shares are listed it is not thought that there would be any breach of the article if a company wishing to buy its shares did so by instructing its stockbroker to acquire them on The Stock Exchange. But so long as the present tax rules (see paragraph 15, above) are maintained this type of re-purchase would presumably have to be banned because it would be impossible for the Revenue (or the company) to tell which shareholders selling on the Exchange should be deemed to have sold to the company and which to third parties[22]. And in any case it would be grossly inequitable to tax some as if the price received was income and others as if it was capital liable only to capital gains tax. In practice, the company would have to circulate an invitation to its shareholders, in which event offers might be received of more shares than the company was prepared to buy. The company ought then to treat each shareholder alike by scaling down each offer pro rata. That, however, would mean that only a proportion - and perhaps a small one - of each member's holding would be bought, with the result that the Revenue would be more likely to insist that the purchases should be treated for tax purposes as a distribution (see paragraph 34 above).

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22. In both cases transfers would be through SEPON.

The circumstances in which the power to re-purchase would be most valuable to a shareholder are where the shares are not listed and he needs to sell. This seems to be the most likely case for a relaxation of the present tax rules. And it is not thought that it would conflict with article 42 of the Second Directive so long as the company adopted a consistent policy towards approaches from shareholders.

64. If the power to re-purchase was extended to investment companies it would enable unit trusts to operate instead as open-ended investment companies or mutual funds. This, as pointed out in paragraph 16 above, they seemingly do not wish to do - though some investment trust companies might welcome the opportunity. It would also necessitate the dismantling of the present regulation of unit trusts and the erection of an entirely new method of control. Although there may in the long term be a case for a new system - as the Jenkins Committee thought (Cmnd 1749 paras 311-324) - neither the Department nor, it is thought, the industry, would wish to face this task at the present time. Hence it is suggested that investment companies should be expressly excluded if this Possibility were adopted.

65. As in the case of private companies (see paragraph 49 above) it would be possible to adopt a more restricted power than that so far considered. For example, the power to re-purchase might be limited to shares which are not listed - the situation in which it would be most needed by shareholders because there was no other market on which they could sell. Or, adopting the three-fold classification proposed in the Green Paper Company Accounting and Disclosure (Cmnd 7654), it could be restricted to companies not in the top tier. Alternatively (or additionally) it could be limited to the purchase and cancellation of redeemable shares prior to the date of redemption. This power might well be conceded in any event. Though it is understood that the re-purchase of listed debenture stock is not popular among

institutional investors and is a practice which The Stock Exchange seeks to regulate and control, there seems no valid reason to continue to draw a distinction in this respect between one type of redeemable security and another. Company law, it is suggested, should permit it in the case of all types and The Stock Exchange be left to regulate its exercise in relation to listed securities.

COMPANIES ACT 1948, SECTION 54

66. One final question is whether, if any of these Possibilities were adopted, section 54 of the 1948 Act, which subject to certain exceptions prohibits a company from providing finance to another person for the purchase of its shares, should be repealed or amended. On the face of it, it may seem anomalous that companies should be given power to purchase their shares themselves but prohibited from providing finance to others for such purchases. This, however, is not the view taken by the Second Directive (see art.23). And it is thought that that view is correct. The abuses that can flow from the latter practices are, as many Inspectors' Reports have shown, both prevalent and likely to be more dangerous than an open purchase by the company itself. This is not to suggest that the section is not inneed of clarification and amendment. The Jenkins Report (Cmnd 1749, paras 170-186) was critical of it - though its suggested amendments are no longer practicable in the light of the Second Directive. But, it is thought, implementation of any of the possibilities canvassed in this paper, would not of itself demand any amendment of section 54 other than that referred to in paragraph 26 above, if Possibility B were adopted.

CONCLUSIONS

67. To sum up:

i. Little purpose would be served merely by expressly permitting companies to issue redeemable equity shares but it should be allowed subject to certain amendments to sections 56 and 58 of 1948 Act: paragraphs 20-24 and 57.

ii. Consideration should be given to the possibility of:

(a) Permitting private companies to operate employee share schemes otherwise than through trustees and, in relation to such schemes, to buy their own shares: paragraphs 25-29.

(b) Permitting private companies to re-purchase their own shares for cancellation: paragraphs 30-49.

(c) In conjunction with (b) or on redemption of redeemable preference shares, providing a less formal means of reducing capital: paragraphs 50-55.

(d) Permitting public companies to re-purchase their own shares for cancellation: paragraphs 58-65

iii. Without substantial changes in the law and practice of corporate taxation little use is likely to be made of these powers but that is not a valid reason for not introducing them. If they are thought to be desirable reforms of company law they should not await changes in tax law: paragraphs 15,17, 29, 34, 63.

Appendix A
Relevant Articles of the 2nd Directive

3. Paragraphs 1 and 2 shall not affect the provisions of the Member States as regards increases in subscribed capital by capitalization of reserves.

4. The laws of a Member State may provide for derogations from paragraph 1 (a) in the case of investment companies with fixed capital.

The expression 'investment company with fixed capital', within the meaning of this paragraph means only those companies:

— the exclusive object of which is to invest their funds in various stocks and shares, land or other assets with the sole aim of spreading investment risks and giving their shareholders the benefit of the results of the management of their assets, and

— which offer their own shares for subscription by the public.

In so far as the laws of Member States make use of this option they shall:

(a) require such companies to include the expression 'investment company' in all documents indicated in Article 4 of Directive 68/151/EEC;

(b) not permit any such company whose net assets fall below the amount specified in paragraph 1 (a) to make a distribution to shareholders when on the closing date of the last financial year the company's total assets as set out in the annual accounts are, or following such distribution would become, less than one-and-a-half times the amount of the company's total liabilities to creditors as set out in the annual accounts;

(c) require any such company which makes a distribution when its net assets fall below the amount specified in paragraph 1 (a) to include in its annual accounts a note to that effect.

Article 16

Any distribution made contrary to Article 15 must be returned by shareholders who have received it if the company proves that these shareholders knew of the irregularity of the distributions made to them, or could not in view of the circumstances have been unaware of it.

Article 17

1. In the case of a serious loss of the subscribed capital, a general meeting of shareholders must be called within the period laid down by the laws of the Member States, to consider whether the company should be wound up or any other measures taken.

2. The amount of a loss deemed to be serious within the meaning of paragraph 1 may not be set by the laws of Member States at a figure higher than half the subscribed capital.

Article 18

1. The shares of a company may not be subscribed for by the company itself.

2. If the shares of a company have been subscribed for by a person acting in his own name, but on behalf of the company, the subscriber shall be deemed to have subscribed for them for his own account.

3. The persons or companies or firms referred to in Article 3 (i) or, in cases of an increase in subscribed capital, the members of the administrative or management body shall be liable to pay for shares subscribed in contravention of this Article.

However, the laws of a Member State may provide that any such person may be released from his obligation if he proves that no fault is attributable to him personally.

Article 19

1. Where the laws of a Member State permit a company to acquire its own shares, either itself or through a person acting in his own name but on the company's behalf, they shall make such acquisitions subject to at least the following conditions:

(a) authorization shall be given by the general meeting, which shall determine the terms and conditions of such acquisitions, and in particular the maximum number of shares to be acquired, the duration of the period for which the authorization is given and which may not exceed 18 months, and, in the case of acquisition for value, the maximum and minimum consideration. Members of the administrative or management body shall be required to satisfy themselves that at the time when each authorized acquisition is effected the conditions referred to in subparagraphs (b), (c) and (d) are respected;

(b) the nominal value or, in the absence thereof, the accountable par of the acquired shares, including shares previously acquired by the company and held by it, and shares acquired by a person acting in his own name but on the company's behalf, may not exceed 10 % of the subscribed capital;

(c) the acquisitions may not have the effect of reducing the net assets below the amount mentioned in Article 15 (1) (a);

(d) only fully paid-up shares may be included in the transaction.

2. The laws of a Member State may provide for derogations from the first sentence of paragraph 1 (a) where the acquisition of a company's own shares is necessary to prevent serious and imminent harm to the company. In such a case, the next general meeting must be informed by the administrative or management body of the reasons for and nature of the acquisitions effected, of the number and nominal value or, in the absence of a nominal value, the accountable par, of the shares acquired, of the proportion of the subscribed capital which they represent, and of the consideration for these shares.

3. Member States may decide not to apply the first sentence of paragraph 1 (a) to shares acquired by either the company itself or by a person acting in his own name but on the company's behalf, for distribution to that company's employees or to the employees of an associate company. Such shares must be distributed within 12 months of their acquisition.

Article 20

1. Member States may decide not to apply Article 19 to:

(a) shares acquired in carrying out a decision to reduce capital, or in the circumstances referred to in Article 39;

(b) shares acquired as a result of a universal transfer of assets;

(c) fully paid-up shares acquired free of charge or by banks and other financial institutions as purchasing commission;

(d) shares acquired by virtue of a legal obligation or resulting from a court ruling for the protection of minority shareholders in the event, particularly, of a merger, a change in the company's object or form, transfer abroad of the registered office, or the introduction of restrictions on the transfer of shares;

(e) shares acquired from a shareholder in the event of failure to pay them up;

(f) shares acquired in order to indemnify minority shareholders in associated companies;

(g) fully paid-up shares acquired under a sale enforced by a court order for the payment of a debt owed to the company by the owner of the shares;

(h) fully paid-up shares issued by an investment company with fixed capital, as defined in the second subparagraph of Article 15 (4), and acquired at the investor's request by that company or by an associate company. Article 15 (4) (a) shall apply. These acquisitions may not have the effect of reducing the net assets below the amount of the subscribed capital plus any reserves the distribution of which is forbidden by law.

2. Shares acquired in the cases listed in paragraph 1 (b) to (g) above must, however, be disposed of within not more than three years of their acquisition unless the nominal value or, in the absence of a nominal value, the accountable par of the shares acquired, including shares which the company may have acquired through a person acting in his own name but on the company's behalf, does not exceed 10 % of the subscribed capital.

3. If the shares are not disposed of within the period laid down in paragraph 2, they must be cancelled. The laws of a Member State may make this cancellation subject to a corresponding reduction in the subscribed capital. Such a reduction must be prescribed where the acquisition of shares to be cancelled results in the net assets having fallen below the amount specified in Article 15 (1) (a).

Article 21

Shares acquired in contravention of Articles 19 and 20 shall be disposed of within one year of their acquisition. Should they not be disposed of within that period, Article 20 (3) shall apply.

Article 22

1. Where the laws of a Member State permit a company to acquire its own shares, either itself or through a person acting in his own name but on the company's behalf, they shall make the holding of these shares at all times subject to at least the following conditions:

(a) among the rights attaching to the shares, the right to vote attaching to the company's own shares shall in any event be suspended;

(b) if the shares are included among the assets shown in the balance sheet, a reserve of the same amount, unavailable for distribution, shall be included among the liabilities.

2. Where the laws of a Member State permit a company to acquire its own shares, either itself or through a person acting in his own name but on the company's behalf, they shall require the annual report to state at least:

(a) the reasons for acquisitions made during the financial year;

(b) the number and nominal value or, in the absence of a nominal value, the accountable par of the shares acquired and disposed of during the financial year and the proportion of the subscribed capital which they represent;

(c) in the case of acquisition or disposal for a value, the consideration for the shares;

(d) the number and nominal value or, in the absence of a nominal value, the accountable par of all the shares acquired and held by the company and the proportion of the subscribed capital which they represent.

Article 23

1. A company may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party.

2. Paragraph 1 shall not apply to transactions concluded by banks and other financial institutions in the normal course of business, nor to transactions effected with a view to the acquisition of shares by or for the company's employees or the employees of an associate company. However, these transactions may not have the effect of reducing the net assets below the amount specified in Article 15 (1) (a).

3. Paragraph 1 shall not apply to transactions effected with a view to acquisition of shares as described in Article 20 (1) (h).

Article 24

1. The acceptance of the company's own shares as security, either by the company itself or through a person acting in his own name but on the company's behalf, shall be treated as an acquisition for the purposes of Articles 19, 20 (1), 22 and 23.

2. The Member States may decide not to apply paragraph 1 to transactions concluded by banks and other financial institutions in the normal course of business.

Article 25

1. Any increase in capital must be decided upon by the general meeting. Both this decision and the increase in the subscribed capital shall be published in the manner laid down by the laws of each Member State, in accordance with Article 3 of Directive 68/151/EEC.

2. Nevertheless, the statutes or instrument of incorporation or the general meeting, the decision of which must be published in accordance with the rules referred to in paragraph 1, may authorize an increase in the subscribed capital up to a maximum amount which they shall fix with due regard for any maximum amount provided for by law. Where appropriate, the increase in the subscribed capital shall be decided on within the limits of the amount fixed, by the company body empowered to do so. The power of such body in this respect shall be for a maximum period of five years and may be renewed one or more times by the general meeting, each time for a period not exceeding five years.

3. Where there are several classes of shares, the decision by the general meeting concerning the increase in capital referred to in paragraph 1 or the authorization to increase the capital referred to in paragraph 2, shall be subject to a separate vote at least for each class of shareholder whose rights are affected by the transaction.

4. This Article shall apply to the issue of all securities which are convertible into shares or which carry the right to subscribe for shares, but not to the conversion of such securities, nor to the exercise of the right to subscribe.

Article 26

Shares issued for a consideration, in the course of an increase in subscribed capital, must be paid up to at

least 25% of their nominal value or, in the absence of a nominal value, of their accountable par. Where provision is made for an issue premium, it must be paid in full.

Article 27

1. Where shares are issued for a consideration other than in cash in the course of an increase in the subscribed capital the consideration must be transferred in full within a period of five years from the decision to increase the subscribed capital.

2. The consideration referred to in paragraph 1 shall be the subject of a report drawn up before the increase in capital is made by one or more experts who are independent of the company and appointed or approved by an administrative or judicial authority. Such experts may be natural persons as well as legal persons and companies and firms under the laws of each Member State.

Article 10 (2) and (3) shall apply.

3. Member States may decide not to apply paragraph 2 in the event of an increase in subscribed capital made in order to give effect to a merger or a public offer for the purchase or exchange of shares and to pay the shareholders of the company which is being absorbed or which is the object of the public offer for the purchase or exchange of shares.

4. Member States may decide not to apply paragraph 2 if all the shares issued in the course of an increase in subscribed capital are issued for a consideration other than in cash to one or more companies, on condition that all the shareholders in the company which receive the consideration have agreed not to have an experts' report drawn up and that the requirements of Article 10 (4) (b) to (f) are met.

Article 28

Where an increase in capital is not fully subscribed, the capital will be increased by the amount of the subscriptions received only if the conditions of the issue so provide.

Article 29

1. Whenever the capital is increased by consideration in cash, the shares must be offered on a pre-emptive basis to shareholders in proportion to the capital represented by their shares.

2. The laws of a Member State:

(a) need not apply paragraph 1 above to shares which carry a limited right to participate in distributions within the meaning of Article 15 and/or in the company's assets in the event of liquidation; or

(b) may permit, where the subscribed capital of a company having several classes of shares carrying different rights with regard to voting, or participation in distributions within the meaning of Article 15 or in assets in the event of liquidation, is increased by issuing new shares in only one of these classes, the right of pre-emption of shareholders of the other classes to be exercised only after the exercise of this right by the shareholders of the class in which the new shares are being issued.

3. Any offer of subscription on a pre-emptive basis and the period within which this right must be exercised shall be published in the national gazette appointed in accordance with Directive 68/151/EEC. However, the laws of a Member State need not provide for such publication where all a company's shares are registered. In such case, all the company's shareholders must be informed in writing. The right of pre-emption must be exercised within a period which shall not be less than 14 days from the date of publication of the offer or from the date of dispatch of the letters to the shareholders.

4. The right of pre-emption may not be restricted or withdrawn by the statutes or instrument of incorporation. This may, however, be done by decision of the general meeting. The administrative or management body shall be required to present to such a meeting a written report indicating the reasons for restriction or withdrawal of the right of pre-emption, and justifying the proposed issue price. The general meeting shall act in accordance with the rules for a quorum and a majority laid down in Article 40. Its decision shall be published in the manner laid down by the laws of each Member State, in accordance with Article 3 of Directive 68/151/EEC.

5. The laws of a Member State may provide that the statutes, the instrument of incorporation or the general meeting, acting in accordance with the rules for a quorum, a majority and publication set out in paragraph 4, may give the power to restrict or

withdraw the right of pre-emption to the company body which is empowered to decide on an increase in subscribed capital within the limits of the authorized capital. This power may not be granted for a longer period than the power for which provision is made in Article 25 (2).

6. Paragraphs 1 to 5 shall apply to the issue of all securities which are convertible into shares or which carry the right to subscribe for shares, but not to the conversion of such securities, nor to the exercice of the right to subscribe.

7. The right of pre-emption is not excluded for the purposes of paragraphs 4 and 5 where, in accordance with the decision to increase the subscribed capital, shares are issued to banks or other financial institutions with a view to their being offered to shareholders of the company in accordance with paragraphs 1 and 3.

Article 30

Any reduction in the subscribed capital, except under a court order, must be subject at least to a decision of the general meeting acting in accordance with the rules for a quorum and a majority laid down in Article 40 without prejudice to Articles 36 and 37. Such decision shall be published in the manner laid down by the laws of each Member State in accordance with Article 3 of Directive 68/151/EEC.

The notice convening the meeting must specify at least the purpose of the reduction and the way in which it is to be carried out.

Article 31

Where there are several classes of shares, the decision by the general meeting concerning a reduction in the subscribed capital shall be subject to a separate vote, at least for each class of shareholders whose rights are affected by the transaction.

Article 32

1. In the event of a reduction in the subscribed capital, at least the creditors whose claims antedate the publication of the decision to make the reduction shall be entitled at least to have the right to obtain security for claims which have not fallen due by the date of that publication. The laws of a Member State shall lay down the conditions for the exercise of this right. They may not set aside such right unless the creditor has adequate safeguards, or unless the latter are not necessary in view of the assets of the company.

2. The laws of the Member States shall also stipulate at least that the reduction shall be void or that no payment may be made for the benefit of the shareholders, until the creditors have obtained satisfaction or a court has decided that their application should not be acceded to.

3. This Article shall apply where the reduction in the subscribed capital is brought about by the total or partial waiving of the payment of the balance of the shareholders' contributions.

Article 33

1. Member States need not apply Article 32 to a reduction in the subscribed capital whose purpose is to offset losses incurred or to include sums of money in a reserve provided that, following this operation, the amount of such reserve is not more than 10% of the reduced subscribed capital. Except in the event of a reduction in the subscribed capital, this reserve may not be distributed to shareholders; it may be used only for offsetting losses incurred or for increasing the subscribed capital by the capitalization of such reserve, in so far as the Member States permit such an operation.

2. In the cases referred to in paragraph 1 the laws of the Member States must at least provide for the measures necessary to ensure that the amounts deriving from the reduction of subscribed capital may not be used for making payments or distributions to shareholders or discharging shareholders from the obligation to make their contributions.

Article 34

The subscribed capital may not be reduced to an amount less than the minimum capital laid down in accordance with Article 6. However, Member States may permit such a reduction if they also provide that the decision to reduce the subscribed capital may take effect only when the subscribed capital is increased to an amount at least equal to the prescribed minimum.

Article 35

Where the laws of a Member State authorize total or partial redemption of the subscribed capital without

* ie 25,000 u.a.

reduction of the latter, they shall at least require that the following conditions are observed:

(a) where the statutes or instrument of incorporation provide for redemption, the latter shall be decided on by the general meeting voting at least under the usual conditions of quorum and majority. Where the statutes or instrument of incorporation do not provide for redemption, the latter shall be decided upon by the general meeting acting at least under the conditions of quorum and majority laid down in Article 40. The decision must be published in the manner prescribed by the laws of each Member State, in accordance with Article 3 of Directive 68/151/EEC;

(b) only sums which are available for distribution within the meaning of Article 15 (1) may be used for redemption purposes;

(c) shareholders whose shares are redeemed shall retain their rights in the company, with the exception of their rights to the repayment of their investment and participation in the distribution of an initial dividend on unredeemed shares.

Article 36

1. Where the laws of a Member State may allow companies to reduce their subscribed capital by compulsory withdrawal of shares, they shall require that at least the following conditions are observed:

(a) compulsory withdrawal must be prescribed or authorized by the statutes or instrument of incorporation before subscription of the shares which are to be withdrawn are subscribed for;

(b) where the compulsory withdrawal is merely authorized by the statutes or instrument of incorporation, it shall be decided upon by the general meeting unless it has been unanimously approved by the shareholders concerned;

(c) the company body deciding on the compulsory withdrawal shall fix the terms and manner thereof, where they have not already been fixed by the statutes or instrument of incorporation;

(d) Article 32 shall apply except in the case of fully paid-up shares which are made available to the company free of charge or are withdrawn using sums available for distribution in accordance with Article 15 (1); in these cases, an amount equal to the nominal value or, in the absence thereof, to the accountable par of all the withdrawn shares must be included in a reserve. Except in the event of a reduction in the subscribed capital this reserve may not be distributed to shareholders. It can be used only for offsetting losses incurred or for increasing the subscribed capital by the capitalization of such reserve, in so far as Member States permit such an operation;

(e) the decision on compulsory withdrawal shall be published in the manner laid down by the laws of each Member State in accordance with Article 3 of Directive 68/151/EEC.

2. Articles 30 (1), 31, 33 and 40 shall not apply to the cases to which paragraph 1 refers.

Article 37

1. In the case of a reduction in the subscribed capital by the withdrawal of shares acquired by the company itself or by a person acting in his own name but on behalf of the company, the withdrawal must always be decided on by the general meeting.

2. Article 32 shall apply unless the shares are fully paid up and are acquired free of charge or using sums available for distribution in accordance with Article 15 (1); in these cases an amount equal to the nominal value or, in the absence thereof, to the accountable par of all the shares withdrawn must be included in a reserve. Except in the event of a reduction in the subscribed capital, this reserve may not be distributed to shareholders. It may be used only for offsetting losses incurred or for increasing the subscribed capital by the capitalization of such reserve, in so far as the Member States permit such an operation.

3. Articles 31, 33 and 40 shall not apply to the cases to which paragraph 1 refers.

Article 38

In the cases covered by Articles 35, 36 (1) (b) and 37 (1), when there are several classes of shares, the decision by the general meeting concerning redemption of the subscribed capital or its reduction by withdrawal of shares shall be subject to a separate vote, at least for each class of shareholders whose rights are affected by the transaction.

Article 39

Where the laws of a Member State authorize companies to issue redeemable shares, they shall require that the following conditions, at least, are complied with for the redemption of such shares:

(a) redemption must be authorized by the company's statutes or instrument of incorporation before the redeemable shares are subscribed for;

(b) the shares must be fully paid up;

(c) the terms and the manner of redemption must be laid down in the company's statutes or instrument of incorporation;

(d) redemption can be only effected by using sums available for distribution in accordance with Article 15 (1) or the proceeds of a new issue made with a view to effecting such redemption;

(e) an amount equal to the nominal value or, in the absence thereof, to the accountable par of all the redeemed shares must be included in a reserve which cannot be distributed to the shareholders, except in the event of a reduction in the subscribed capital; it may be used only for the purpose of increasing the subscribed capital by the capitalization of reserves;

(f) subparagraph (e) shall not apply to redemption using the proceeds of a new issue made with a view to effecting such redemption;

(g) where provision is made for the payment of a premium to shareholders in consequence of a redemption, the premium may be paid only from sums available for distribution in accordance with Article 15 (1), or from a reserve other than that referred to in (e) which may not be distributed to shareholders except in the event of a reduction in the subscribed capital; this reserve may be used only for the purposes of increasing the subscribed capital by the capitalization of reserves or for covering the costs referred to in Article 3 (j) or the cost of issuing shares or debentures or for the payment of a premium to holders of redeemable shares or debentures;

(h) notification of redemption shall be published in the manner laid down by the laws of each Member State in accordance with Article 3 of Directive 68/151/EEC.

Article 40

1. The laws of the Member States shall provide that the decisions referred to in Articles 29 (4) and (5), 30, 31, 35 and 38 must be taken at least by a majority of not less than two-thirds of the votes attaching to the securities or the subscribed capital represented.

2. The laws of the Member States may, however, lay down that a simple majority of the votes specified in paragraph 1 is sufficient when at least half the subscribed capital is represented.

Article 41

1. Member States may derogate from Article 9 (1), Article 19 (1) (a), first sentence, and (b) and from Articles 25, 26 and 29 to the extent that such derogations are necessary for the adoption or application of provisions designed to encourage the participation of employees, or other groups of persons defined by national law, in the capital of undertakings.

2. Member States may decide not to apply Article 19 (1) (a), first sentence, and Articles 30, 31, 36, 37, 38 and 39 to companies incorporated under a special law which issue both capital shares and workers' shares, the latter being issued to the company's employees as a body, who are represented at general meetings of shareholders by delegates having the right to vote.

Article 42

For the purposes of the implementation of this Directive, the laws of the Member States shall ensure equal treatment to all shareholders who are in the same position.

Article 43

1. Member States shall bring into force the laws, regulations and administrative provisions needed in order to comply with this Directive within two years of its notification. They shall forthwith inform the Commission thereof.

2. Member States may decide not to apply Article 3 (g), (i), (j) and (k) to companies already in existence at the date of entry into force of the provisions referred to in paragraph 1.

Appendix B

Draft Company Laws of Jersey

Redeemable Shares

50 (1) Subject to the maintenance by the company of its minimum paid up capital, a company may by its Articles designate any of its shares as Redeemable Shares and any shares so designated shall be available for issue by the company on such terms as to redemption as the Articles shall specify: Provided that

(a) no such share shall be redeemed unless there shall have been delivered to the Commercial Relations Officer not more than fourteen days previous to the date on which redemption is to be effected a statement specifying the shares to be redeemed and a certificate signed by a majority of the directors confirming that at the date of such certificate the company is not insolvent and that its minimum paid up capital has not been diminished and will not be diminished as a result of the proposed redemption and that the company will not be made insolvent if the redemption is completed and that the company has adequate capital facilities for the conduct of its business without resort to the capital to be redeemed and such certificate shall be counter-signed by the auditor (if any) of the company; and

(b) any amount paid on redemption in excess of the issue price of the shares to be redeemed shall be paid out of the Share Premium Account or out of the Revenue Surplus Account or out of the proceeds of a fresh issue of shares made for purposes of the redemption as provided in Paragraph (4) of this Article.

(2) If a company shall fail to redeem any Redeemable Share on the terms specified in its Articles the holder of any Redeemable Share in respect of which default has been made shall be deemed to be a creditor of the company for the purpose of presentation of an Insolvency Petition against the company without such holder being required to institute formal proceedings against the company by reason of the default.

(3) Where a company has designated any part of its Share Capital as Redeemable Shares in any statement which the company causes to make public as to its Share Capital the company shall disclose in conspicuous terms the amount of its Share Capital so designated and where the terms of redemption provides a fixed term or period during which redemption is to or can take place the relevant year date or dates shall also be stated.

(4) For the purpose of capital duty if any share capital is created by the company for the specific purpose so declared in the requisite resolution of providing monies towards the redemption of Redeemable Shares and the Redeemable Shares are redeemed within one month of the new shares being created the Share Capital shall not be deemed to have been increased except to the extent that such Share Capital exceeds the nominal capital represented by the shares which have been redeemed.

(5) Whenever a company redeems any of its shares under the provisions of this Article it shall give notice in writing to each holder of the shares redeemed reminding such holder of the provisions of Article 38 of the Insolvency (Jersey) Law, 197 , whereby the amount paid on redemption may be recoverable by the Insolvency Commissioner.

Reduction of Capital

51 (1) A limited company may, subject to confirmation by the Commercial Relations Officer, by Special Resolution reduce its share capital in any manner: Provided that no such reduction shall be effective to the extent that it diminishes the prescribed minimum paid up capital.

(2) Within fourteen days after the passing of a Special Resolution to reduce capital the company shall deliver to the Commercial Relations Officer a certified copy of the Special Resolution and where the reduction involves repayment of capital to any member of the company together with a certificate in similar terms to the certificate referred to in Paragraph (1) of Article 50 of this Law and, unless the company has no creditors or all the creditors have signified their consent in writing to the proposed reduction of capital, there shall also be furnished to the Commercial Relations Officer a guarantee by a bank, or other financial institution acceptable to the Commercial Relations Officer, providing security for payment of creditors to such amount as the Commercial Relations Officer shall think in all the circumstances proper or evidence satisfactory to the Commercial Relations Officer that claims of creditors are adequately secured.

(3) On receipt of the documents and particulars referred to in the last preceding paragraph of this Article the Commercial Relations Officer may in any particular case, at the expense of the company, cause a notice to be published in the Jersey Gazette, and in any newspaper published outside the Island if the Commercial Relations Officer so determines having regard to the nature of the company's business, giving details of the proposed reduction, and, unless objection is made in writing to the Commercial Relations Officer pursuant to Paragraph (4) of this Article within fourteen days of such notice appearing or the Commercial Relations Officer determines to dispense with such advertisement, the Commercial Relations Officer shall confirm the reduction and register details thereof in the file of the company at the Companies Registry and issue a certificate of confirmation which shall specify the details of the share capital of the company so reduced.

(4) Where any such advertisement is published as provided in Paragraph (3) of this Article, any creditor of the company who at the date of the passing of the Special Resolution is entitled to any debt or claim against the company, whether such debt or claim be present or future, certain or contingent, ascertained or sounding

only in damages, shall be entitled to object to the reduction by notice in writing specifying his objection and the extent and nature of his claim against the company, such notice to be delivered to the Commercial Relations Officer (and a copy served on the company) within the period of fourteen days specified in Paragraph (3) of this Article.

(5) Where any objection is made pursuant to Paragraph (4) of this Article the Commercial Relations Officer shall within seven days of the objection being made consider the reason for the objection and any representations made by the objector and the company and may refuse to confirm the Resolution for the reduction or may confirm the resolution for reduction absolutely or subject to such conditions as he may impose relating to the company providing security for such creditor, and for this purpose the Commercial Relations Officer may modify the resolution which shall then be registered as so modified.

(6) A special resolution for a reduction shall take effect on and not before the issue by the Commercial Relations Officer of his certificate of confirmation and a copy of the said certificate shall accompany every copy of the Article of the company issued by the company after the date of such certificate.

(7) If any officer of the company:

(a) wilfully conceals the name of any creditor entitled to oppose the confirmation; or

(b) wilfully misrepresents to the Commercial Relations Officer the nature or amount of the debt or claim of any creditor; or

(c) aids, or abets or is privy to any such concealment or misrepresentation.

he shall be personally liable to pay to such creditor the amount of his debt or claim to the extent to which it is not paid by the company and shall be guilty of an offence and liable on conviction to imprisonment for a term not exceeding two years or to a fine not exceeding £1,000 or both.

(8) If any resolution for reduction in capital shall vary the rights attached to any class of shares the company shall satisfy the Commercial Relations Officer that all necessary consents to the reduction shall have been obtained pursuant to Article 38 of this Law.

(9) An Unlimited Company may reduce its share capital in any manner by unanimous resolution without confirmation by the Commercial Relations Officer.

(10) An Investors Unlimited Company may only reduce its Investors Share Capital by following the procedure prescribed in this Law as to reduction of share capital or redemption of shares and such a company may not reduce its unlimited share capital except with the class consent of the holders of its Investors Share Capital.

(11) Whenever a company reduces its share capital by repayment to any member under the provisions of this Article it shall give notice in writing to each such member reminding him of the provisions of Article 38 of the Insolvency (Jersey) Law 197 whereby the amount repaid may be recoverable by the Insolvency Commissioner.

Share Warrants to Bearer or Bearer Shares

52 (1) A public company may issue bearer share certificates only if the Commercial Relations Officer grants it permission to do so and in granting such permission the Commercial Relations Officer may impose such conditions as he considers proper.

(2) Bearer share certificates are negotiable instruments transferable by delivery and a purchaser for money or money's worth of shares represented by a bearer share certificate who has no knowledge of any defect in the title of the person from whom he acquires them obtains ownership of the shares free from the title of and any claim by any former holder.

(3) A company which issues a bearer share certificate shall provide for the payment of dividends by the issue of coupons to bearer and such coupons shall also be negotiable instruments and shall be governed by Paragraph (2) of this Article.

(4) Regulations under this Law may be made for the purpose of altering the rights of public companies generally, or of any public company specifically, to issue bearer share certificates or limiting the time during which such certificates may be valid and providing for the holders to become registered members of the company within a prescribed period on such terms as the regulations may prescribe or for providing that such certificates shall be deposited with an Authorised Depositary resident in the Island.

(5) The holder of a bearer share certificate may exercise the voting rights attached to the shares comprised in his certificate only through an Authorised Depositary resident in Jersey.

(6) Where any voting rights are exercised pursuant to Paragraph (5) of this Article the company shall accept a certificate duly signed by the Authorised Depositary as sufficient evidence to admit the bearer shares to vote.

Incl P51

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

Martin Hall Esq
Private Secretary
Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1

29 October 1979

Dear Martin

DIRECTORS' DUTY TO HAVE REGARD TO EMPLOYEES' INTERESTS

My Secretary of State wrote to the Chancellor on 25 October on this subject, and mentioned that the Law Officers had been asked to advise on the proposed amendment to the Companies Bill. The letter should therefore have subsequently referred not only to the Attorney General's letter of 18 October but also to the Lord Advocate's letter of the same date. The latter is of course also available to those who have not seen it.

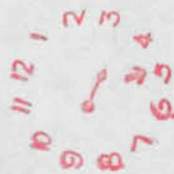
I am sending copies of this letter to the Private Secretaries to the Prime Minister, the members of E Committee, the Attorney General, the Lord Advocate and Sir Robert Armstrong.

Yours sincerely

John Symes

J M D SYMES
Private Secretary

29 OCT 1979



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DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

The Rt Hon Sir Geoffrey Howe, QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London, SW1P 3HE

25 October 1979

Dear Geoffrey.

DIRECTORS' DUTY TO HAVE REGARD TO EMPLOYEES' INTERESTS

My Companies Bill had its Second Reading on 22 October and will shortly go into Committee.

There was pressure in the Lords for the inclusion of a number of provisions from the last Government's 1978 Bill, which fell at the dissolution of Parliament. The Opposition had announced their intention of tabling amendments on these points, and had proposed to divide the House on the Second Reading on the grounds that they were omitted. Both on merits, and because I want to retain the political initiative, I reached the view that we should ourselves propose to widen the Bill to cover some of these points. The Minister of State gave notice of this intention in moving the Second Reading, and it has been widely welcomed.

I wrote to the Employment Secretary, the Industry Secretary and other colleagues last week about one provision where there is a particularly difficult balance to strike. This is the proposal that directors of companies should be put under a new statutory duty to have regard to the interests of employees. In principle, I feel that we must do this - the Employment Secretary and I are on public record to that effect. My main concern has been that legislation should not expose boards of companies to protracted and vexatious litigation. The last Government's proposals were

From the Secretary of State

strongly criticised on these grounds by the CBI. The Minister of State (Industry) wrote last week to suggest that we should be "completely satisfied" on this point.

I have accordingly sought the advice of the Law Officers on the provision we should propose. The Attorney General's views are set out in his letter of 18 October which I have asked should be made available to you and other recipients of this letter who have not already seen it. If I may venture to summarise, the Attorney General considers that the possibility of litigation could not be completely discounted, especially in the early days while the effect of the new provision was being tested, but that the prospect of successful actions would be small.

My own conclusion is that the risk, thus defined, is acceptable. A provision which offered a water-tight guarantee against any risk of litigation - however remote - is unattainable, unless in so weak a form as to be derisory. We have substantially reduced the risk, by proposing that the directors' new duty should be owed to the company (not - as the last Government proposed - to the employees) and should be enforceable only by the company. My proposal will no doubt be criticised by the TUC as inadequate in this respect, but less so than failure to tackle the matter at all. The Employment Secretary sees it as a positive contribution to his current policies.

Accordingly, Cecil Parkinson announced in the Second Reading debate that the Government hoped it would be possible to bring forward an amendment, that we believed that we had succeeded in drafting a suitable cluase and that unless unexpected difficulties appeared we would table this provision in Committee.

Since I do not believe we could completely eliminate the risk of vexatious litigation and I believe we have minimised that risk as

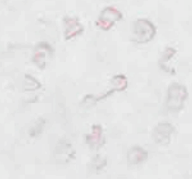
From the Secretary of State

far as possible, I am therefore writing to inform you of my intention to proceed with this amendment.

I am copying this letter to the Prime Minister, to other Members of E Committee, to the Attorney General and to Sir John Hunt.

Yours ever
John.

JOHN NOTT



✓ MJ

From the
Minister ~~of State~~
for Trade's Office

DEPARTMENT OF TRADE
1 VICTORIA STREET
LONDON SW1H OET

TELEPHONE DIRECT LINE 01 215 5144
SWITCHBOARD 01 215 7877

Mr R E S Prescott
Private Secretary to the Paymaster General
Privy Council Office
Whitehall
London
SW1A 2AT

19 October 1979

Dear Mr. Prescott,

COMPANIES BILL: INSIDER DEALING

In his letter of 15 October to the Secretary of State for Industry, a copy of which is enclosed, my Secretary of State wrote that our revised proposals on insider dealing should be the subject of wider consultation before being introduced into a Bill. We have now received the agreement of colleagues that, in moving the Second Reading of the Companies Bill on Monday, my Minister should say that we shall be publishing that day a consultative note with draft clauses on insider dealing with a view to these being added to the Bill if we are satisfied that we have got the approach right.

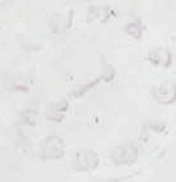
I enclose for your information a copy of the foreword to the consultative note, (the text itself is entirely technical, consisting of the draft clauses) which we shall be publishing on Monday. We shall simultaneously be issuing a Press Notice which will refer to the consultative note and to my Minister's announcement that the Government intend to table new clauses dealing with the duty of directors towards employees, and with directors' loans and other conflicts of interest.

A copy of this letter, and enclosures, goes to Nick Sanders at No 10, to Murdo Maclean in the Chief Whip's office and to John Stevens in the Chancellor of the Duchy's Office.

Yours ever,

Christine Bargery

CHRISTINE BARGERY
Private Secretary to the Minister
for Trade (CECIL PARKINSON)



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With the compliments of
the Attorney-General

√ MS

Attorney General's Chambers,
Law Officers' Department,
Royal Courts of Justice,
Strand. W.C.2A 2LL

01 405 7641 Extn. 3201

ROYAL COURTS OF JUSTICE
LONDON, WC2A 2LL

01-405 7641 Extn 3201

18 October 1979

The Rt Hon John Nott MP
Secretary of State for Trade
Department of Trade
1 Victoria Street
LONDON S W 1

Dear John.

This letter not copied to No.10.

COMPANIES BILL
DIRECTORS' DUTY TO HAVE REGARD TO THE INTERESTS OF EMPLOYEES

Thank you for your letter of 11 October. I have since had further information from your officials and yesterday had a conference with them and Parliamentary Counsel. My advice is as follows on the draft clause in the version sent with your letter.

2. At least in the English courts I do not think that employees could successfully argue that the duty imposed on directors by the clause is enforceable by them. In other words they could not sustain legal proceedings if they were employees but not members. In my view the wording of the clause precludes any action by employees in that capacity. I understand that the position in Scotland may be different but the Lord Advocate will advise on this.

3. It would, of course, be possible for an employee who was also a shareholder to mount an action under the clause but one should bear in mind that it is possible under the present law for such a person to bring proceedings alleging conduct by the directors which is oppressive to a minority of the members.

4. From this I infer that the real question is whether an action by an employee member under the clause, or by a member who was not an employee but nevertheless alleged a breach of the duty by directors, would be likely to succeed in circumstances where such an action would not be likely to succeed at present.

5. I cannot give you a categorical "no" in answer to this question but I think the practical consequences of the clause would be slight in terms of directors' existing general duty to act bona fide in the interests of their company, in terms of the factors they have to take into account in discharging that duty, and hence of the rights which minorities currently have to restrain oppressive conduct by them.

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6. In particular, I do not think the new clause would enable a member to bring a successful action where the interests affected were solely his as an employee, or if he was not an employee, those of other employees in that capacity. It would be necessary to show (as it is at present) that some legitimate interest of the company, expressed as the interests of a prejudiced minority of the members, had been affected. But as I understand it, this would satisfy the objectives you have in mind in introducing the new clause.

7. You go on to ask whether, even if there is no prospect of successful litigation by employees to enforce the duty, there might still be vexatious claims that would disrupt the management of companies.

8. It follows from what I have said that any action by employees who did not hold shares would be likely to be struck out at the interlocutory stage in legal proceedings. This might not be sufficient to avoid disruption, especially to small companies, but I think such actions would probably be confined to a short period following the enactment of the clause, after which the lesson would have been learnt.

9. There is also, of course, the possibility of members' actions having no substantial merit, which could not so easily be defeated in limine. I cannot advise you that there would be no such actions, because nuisance litigants are a fact of life, but I think the most likely outcome of the clause would be test cases designed to show that it confers no appreciable benefits on employees. Such test cases would be likely to go on appeal and to that extent cause prolonged disruption, but once the scope of the clause had been established by them litigation would probably not be frequent. Test cases could, of course, bring pressure for further changes in the law, but that is not a matter for me at this stage.

10. My general conclusion is this. In the proper performance of their functions directors have in law to bear in mind a variety of factors, and these will include the interests of employees in cases where the relationship between them and the company in which they work cannot be separated from the interests of the company as a whole. This is the case at present. I see the clause as doing little more than giving statutory expression to this principle and I doubt whether, save in the most exceptional cases, it will alter the balance of considerations which is relevant to the duty of directors

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to act bona fide in the interests of the company. The duty imposed by the clause is, in any event, weak as it is only a duty to have regard to the interests of employees and not to act in accordance with those interests.

11. Here I must add that as a Law Officer I always dislike legislation which on proper analysis appears to have no substantial effect, and is enacted for reasons which all too soon become apparent, not only to the Opposition but also to the courts who have to construe it.

12. Furthermore in giving this advice I am conscious that I may be called upon to explain to the Commons what are the legal effects of this clause. It will be apparent from this letter that I shall not be able to reject criticism that these effects are small and that the clause confers very little additional benefit on employees; in other words that the clause may properly be described as cosmetic. These are obviously factors which you will have to take into account in deciding whether to introduce the clause, but I would at least be able to say something on the lines of paragraph 10 of this letter without drawing attention to the more negative aspects (though this will undoubtedly be done by the Opposition).

13. Finally I should say that I see very little difference in substance between the first and second versions of subsection (2) of the clause, but I prefer the second version for the reasons already given by Parliamentary Counsel. In my view he has performed extremely well the unenviable task of drafting a clause which appears to confer benefits on employees but on analysis does not change the law significantly.

14. This is copied to the Prime Minister, Jim Prior, James Mackay, Sir John Hunt and Parliamentary Counsel.

Yours ever.

Michael.

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