COMPANIES
AND
SECURITIES
LAW REVIEW COMMITTEE

REPORT TO
THE MINISTERIAL COUNCIL

A COMPANY'S PURCHASE OF ITS OWN SHARES

September 1987

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REPORT OF THE COMPANIES AND SECURITIES LAW REVIEW COMMITTEE ON A COMPANY'S PURCHASE OF ITS OWN SHARES

TO: The Ministerial Council for Companies and Securities

The CSLRC presents to the Ministerial Council its Report on A Company's Purchase of Its Own Shares. This is the Sixth Report of the Committee, the others being:

* Report on the Takeover Threshold (November 1984)
* Report on Partial Takeover Bids (August 1985)
* Report on Forms of Legal Organisation for Small Business Enterprises (September 1985)
* Report on the Civil Liability of Company Auditors (September 1986)
* Report on the Issue of Shares for Non-Cash Consideration and Treatment of Share Premiums (September 1986).

Terms of Reference

The Committee received a reference from the Ministerial Council to inquire into and review the corporate form including:

* the circumstances in which companies may be permitted to purchase their own shares.

The Committee considered that review of this matter was timely in consequence of:

* the indecisive outcome of the Interstate Corporate Affairs Commission's review of the law concerning companies acquiring their own shares, and the recommendations of the Campbell Committee that further examination of this issue be undertaken;

* the existence of provisions in the USA, Canada, UK and other EEC countries allowing companies to buy their own shares; and

* the apparent shortcomings in the existing s129 prohibition.

In June 1986 the Committee published Discussion Paper No. 5: "A Company's Purchase of its own Shares"; a copy of which is reproduced in Appendix B of this Report. A list of respondents to this Discussion Paper is found in Appendix A.

In this Report the Committee looks to:

* the merits of introducing a self-purchase power; and
* the regulatory procedures that might govern the exercise of that power.

Structure of the Report

Part I of this Report examines the various functions to be served by a self-purchase power and the possible problems that may arise from its use. It covers the matters dealt with in Chapters 1-4 of the Discussion Paper. The Committee concludes that there are sufficient compelling reasons to support the introduction of a self-purchase power and that it

is possible, by suitable procedural requirements and protective restrictions, to overcome possible misuse of the power.

Part II of the Report discusses in detail the various issues arising from implementing a self-purchase power and sets out a series of recommendations for its regulation. It covers the matters dealt with in Chapter 5 of the Discussion Paper.

Financial Assistance

This Report does not address the matter of a company providing financial assistance for the purchase of its shares. The Committee considers this a different issue for separate review.

Principal Recommendation

The Committee recommends that the Companies Code s129(1) (b)(i) be amended to enable companies to "directly" acquire their own shares in compliance with stipulated procedural and solvency requirements. Companies should also be entitled to purchase their options over unissued shares. The Committee would not support repeal of s129(1)(b)(ii) or s129(1) (c) (i) & (ii).

Summary of Recommended Procedures

The Committee recommends that a company, if empowered by its Memorandum or Articles, may acquire its shares through on-market purchases, pari passu offers to all shareholders, or selective buy-backs from individual members. A summary of the recommended procedures for these self-purchases is set out, cross-referenced to relevant paragraphs of the Report.

The Committee also recommends a simplified procedure for the purchase by companies of their options over unissued shares: [102] - [105].

Types of Self Purchases	(1) On Market Purchases/Pari Passu Offers	(2) Selective Self-Purchases (other than (3))	(3) Odd lot and Employee Share Scheme Selective Self-Purchases
Procedural Requirements			
Source of the Self-Purchase Power	(1)(2)(3) - Enabling Article or Memorandum, subject to a sunset provision: [44] - [49]		
Persons Authorized	(1) Directors - 10% of shares in any 12 month period without prior shareholder authorization: [54] (2) Shareholders by special resolution, excluding vendors and their associates: [54] (3) Directors: [54] (1) Shareholders by ordinary resolution for excess purchases in that period: [54]		
Information to the Decision Makers	(1) Notice of Shareholder meeting to include stipulated requirements: [57] - [59]	(2) Notice of Shareholder meeting to include stipulated requirements: [57]; [58]; [60]	(3) Directors in possession of requisite information: [56]
Terms of the Authorization	(1) Shareholders to determine the terms and conditions of acquisition programmes: [631- [72]	(2) Shareholders to approve each selective self-purchase: [73] - [74]	(3) Odd lots: not apply; employee shares: shareholders to settle terms when approving scheme: [54]
Appeal Procedures	(1)(2)(3) - Application of existing appeal grounds: [77] - [80]		
Status of Irregularly Authorized Transactions	(1)(2)(3) - All completed irregular self-purchases to be valid: [77] - [80]		

Financial Considerations	(1)(2)(3) - A declaration of solvency obligation for non-dissenting directors, with consequent personal liability in the event of insolvency: [81] - [92].

Method of Purchase	(1) [941 - [95] (2) [97]- [99] (3) [54]
Types of Self-Purchases	(1)(2)(3) - Partly paid shares and fully paid shares to be capable of acquisition: [100]-[101]
Volume, Price and Timing Controls	(1)(2)(3) - No specific controls recommended
Advance Disclosure of Intended On-Market Self-Purchases	(1) [1121 - [121] (2) Not apply (3) Not apply
Disclosure of Completed Transactions	(1)(2)(3) - A separate self-purchase register to be created: [122] - [124]
Status of Self-Purchased Shares	(1)(2)(3) - All acquired shares to be cancelled: [125] - [128]
Accounting for Self-Purchases	(1)(2)(3) - Any acquisition premium to be written off against the share premium account and distributable profits: [130]
Executory and Partially Performed Contracts	(1)(2)(3) - Such contracts to be enforceable subject to the solvency requirements: [131] - [133]
Self-Purchase Related Debt	(1)(2)(3) - Application of Companies Code s360(1)(k): [134] - [135]
Self-Purchase as a Take-Over Defence	(1)(2)(3) - Shareholder approval of self-purchases during the course of a take-over bid: [136] - [142]
CASA and Substantial Shareholding Implications	(1)(2)(3) - Exclusion of self-purchases from CASA: [143]; [147] - [152]; company to notify all members of new issued share capital following a 'notifiable change': [146]
Criminal Liability	(1)(2)(3) - Liability of defaulting officers and other persons party to a breach: [153] - [157]

Civil Liability (1)(2)(3) - Compensation liability for defaulting officers and other persons party to a breach: [158] - [160]

PART I
THE FUNCTIONS OF A SELF-PURCHASE POWER

Benefits of a Self-Purchase Power

[1] The fundamental issue to be addressed in Part I of this Report is whether the existing statutory prohibition on a company acquiring its own shares (Companies Code s129(1)) should be abandoned and replaced with a permissive power allowing for such acquisitions. The Committee sought in the Discussion Paper to identify the various grounds that may be advanced in support of a self-purchase power. In this Part the Committee summarises what it considers to be valid arguments for introducing this power, under the following format:

* Limitations of the Existing Regulatory Regime
* Potential Benefits for Listed Public Companies and the Securities Market
* Potential Benefits for Non-Listed Companies
* Potential Benefits for Both Listed and Non-Listed Companies
* Other Potential Benefits

Limitations of the Existing Regulatory Regime

[2] The terms of the relevant Companies legislation, including the elements of the statutory prohibition and its exceptions are set out in the Discussion Paper [108] -[143]. The Committee perceives that these provisions, in practice, have various unsatisfactory features:

* shortcomings in the traditional capital maintenance rationale behind the statutory prohibition: Discussion Paper [101] - [107];

* the capacity of companies, in part, to circumvent the prohibition on buy-backs by acquiring an interest in one or more of their shareholders: Discussion Paper [131] - [135], and the difficulties of advancing a workable policy response to this possible "loophole" other than by relaxing the barriers to corporate self-purchases: Discussion Paper [136] - [142]; and

* the seeming inability of the legislation (Companies Code s123) to respond expeditiously and flexibly to a company's need, or preference for, an excess capital reduction (similar in effect to a buy-back): Discussion Paper [129]; [130]; [320]; [321].

Potential Benefits for Listed Public Companies and the Securities Market

[3] The Committee sees the following advantages for listed public companies and the securities market in the introduction of a self-purchase power:

* Improving the competitiveness of Australian securities in international financial markets. It may be appropriate at a time when the financial market is being rapidly internationalised to introduce a self-purchase practice that is recognised and applied in North America and the EEC. Australian companies may be at a disadvantage when competing on world share markets if they lack the flexibility of control over their equity that UK, Canadian and US companies enjoy. Similarly overseas companies may be discouraged from incorporating in Australia while the self-purchase restrictions remain.

* Increased capital mobility in the securities market. A self-purchase power may act as a conduit for excess monetary capacity and as a means of increasing capital flow and depth in the securities market: Discussion Paper [326].

* Increased market information. An announcement of a proposed self-purchase may supply new or further information to the market about a company's operating performance and future projects: Discussion Paper [327].

* Self-purchases as a takeover defence. The Committee sees force in the argument that exercise of the self-purchase power by target companies may create a more competitive price environment and thereby generate greater returns to shareholders, without necessarily prejudicing the interests of offerors: Discussion Paper [329] - [335]. The potential for misuse of the power in this context can be corrected by regulatory controls: see [136]-[141].

* Self-purchases as an alternative to a takeover bid. Buy-backs may reduce the possibility of uneconomic take-over activity by providing potential offeror companies with an alternative means of adjusting their level of capital and gearing ratio. The current prohibition may be a positive "spur" to takeover activity.

* Self-investment. A self-purchase may be a prudent commercial investment by a company when the current market price of its shares is less than their perceived long-term value: Discussion Paper [315] -[317].

* Diminution of administrative overheads. Selective self-purchases may be used to eliminate fractional shares and odd lot holdings which may otherwise be costly for companies to administer: Discussion Paper [323]. This may also assist small shareholders to sell their shares without the overhead costs associated with market trading.

Management buy-outs and leveraged recapitalizations. The self-purchase power may be utilised to restore "close control" to public companies by eliminating or reducing the level of public equity participation[1]. There may be benefits to the company and its future shareholders in this conversion, notwithstanding the criticism that this may be contrary to the sentiment of encouraging wider public equity participation: Discussion Paper [336] - [337].

Potential Benefits for Non-Listed Companies

[4] The Committee believes that the self-purchase power may be particularly beneficial to smaller or "closely held" proprietary companies. These advantages include:

* Retention of power in small companies. Application of the self-purchase power may preserve the balance of interests of continuing shareholders: Discussion Paper [303].

* Enhanced opportunities for equity raising. A self-purchase power may enable proprietors of non-listed companies to raise equity capital without running the risk of jeopardising or forever surrendering control of the company: Discussion Paper [304] - [306].

* Shareholder liquidity plans. Introduction of the self-purchase power may encourage the development of shareholder liquidity arrangements in smaller companies: Discussion Paper [307] - [310].

1. For an explanation of the development and structuring of these arrangements in the USA see Lederman L; Goroff M; 'Recapitalization Transactions' The Review of Securities and Commodities Regulation Vol. 19 No 20 (1986) 241-249. See also DeMott D; 'Directors' Duties in a Management Buy-Out' The Sydney Law Review (forthcoming).

* Compromise of a shareholder's indebtedness. It may be in company's interest to settle its claim against a debtor shareholder, in whole or part, by recovering the member's shares: Discussion Paper [311].

Potential Benefits for Both Listed and Non-Listed Companies

[5] A self-purchase power may provide other benefits for both listed and unlisted companies:

* Encouragement of employee share schemes. A self-purchase power could facilitate these schemes by enabling a company to acquire the shares of departing employees: Discussion Paper [312].

* Managerial efficiency. It may contribute to the efficient or harmonious management of a company's business if dissident or apathetic shareholders can be bought out by the company: Discussion Paper [313]-[314].

* Financial restructuring. A company may reach a point in its development where, through lack of new investment opportunities, contraction of its market, or a decision to scale down its operations, it is desirable to reduce its equity base. Self-purchases would enable the company to adjust its equity base and its debt to equity ratio to accommodate these changing requirements: Discussion Paper [318]-[319].

* Preferable method of issued share capital reduction for excess equity companies. Companies with excess equity may be more willing to return surplus resources to shareholders through a self-purchase programme rather than face the procedural complexities of a capital reduction under the Companies Code s123. The self-purchase power may

therefore encourage the retirement of corporate capital no longer needed: Discussion Paper [320]-[321].

Other potential benefits

[6] Introduction of a self-purchase power may stimulate the development of new corporate forms, e.g.:

* Open-ended investment companies (mutual funds). The self-purchase power may encourage the creation of open-ended investment companies as an alternative to unit trusts: Discussion Paper [324]-[325].

[7] The Committee recognises that promotion of these new entities may require a review of their structure, powers and obligations. The Committee sees this task as outside the terms of reference of this Report, but notes in passing the Canadian Federal legislation dealing with mutual funds as a possible regulatory model.

Summary

[8] In identifying these possible benefits, the Committee realizes that a number of the arguments advanced contain assumptions about corporate and market behaviour which, in the abstract, can neither be proved nor disproved. However the Committee believes that there is sufficient force in the combination of potential benefits to warrant the introduction of a self-purchase power in the Companies legislation. All submissions received by the Committee supported buy-backs in principle. Furthermore the Committee believes it is possible, by appropriate regulatory methods, to overcome the foreseeable problems associated with the exercise of a buy-back power.

Problems Arising from the Self-Purchase Power

[9] The Committee recognises that an unregulated self-purchase power could be open to substantial misuse. Possible abuses were referred to in Chapter 4 of the Discussion Paper:

* Internal Inequities
* Market Price Manipulation
* Insider Trading
* Improper Attempts to Secure or Consolidate Corporate Control
* Greenmail
* Increasing the Risk of Corporate Failure.

[10] It is the Committee's view that these problems can be overcome by suitable procedural controls.

Internal Inequities

[11] An unregulated self-purchase power may result in improper discrimination between shareholders, e.g. where favoured members are bought out at a substantial premium, or where a company acquires shares at a marked undervalue, to the detriment of vendor shareholders.

[12] This potential for disparate treatment could be minimised by stipulating that all selective buy-backs with limited exceptions (see [54]) must be authorised by special resolution of members, excluding vendor shareholders and their associates. The Committee believes that allowing for selective acquisitions, with the informed consent of the independent shareholders, would be preferable to their total prohibition: see further [97]-[99]. In addition the Committee favours the requirement that a company make full public disclosure in advance of its on-market acquisitions, thereby ensuring that all shareholders will have an equal

opportunity to participate in these transactions: see further [112]-[121]. These requirements, together with the existing statutory and common law fiduciary duty doctrines (e.g. Companies Code s229; Coleman v Myers [1977] 2 NZLR 225) and other possible shareholder remedies (e.g. Companies Code s320; 364(1) (f) (fa) (fb) (j); s574) would be strong deterrents to inequitable practices.

Market Price Manipulation

[13] Any substantial self-purchase by a listed public company has the potential to increase significantly the market price of its shares, thereby providing company controllers with an opportunity to encourage price inflation. However share purchases for the purpose of market rigging would be in breach of Part X of the Securities Industry Code (cf North v Marra Developments Ltd. (1981) 37 ALR 341). In addition the public disclosure obligations recommended by the Committee to apply to all on-market self-purchases (see [112]-[121]) are designed to inform the market of the presence of the company as a purchaser, thereby assisting shareholders and investors to make more informed investment decisions.

[14] The Discussion Paper: [242]-[243]; [5005]-[5062] mooted the possible introduction of US SEC Rule 10(b)-18[2] which provides buy-back companies with an immunity from possible liability for market price manipulation, provided certain limits on the volume, price and timing of acquisitions are observed.

[15] The Committee saw an immunity rule as overcoming uncertainties arising from the application to self-purchases of the Securities Industry Code Part X, while having the merit of encouraging companies to acquire their shares at a regulated pace. However, it appears to the Committee that any

2. US Securities and Exchange Commission Release No. 34 - 19244 (1982). See generally Feller L and Camberlin M; "Issuer Repurchases" The Review of Securities Regulation Vol. 17 No. 1 (1984) 993-998.

proposed rule could be too inflexible, particularly with a highly fluid market or in the context of takeover bids. Furthermore the commercial community may inadvertently gain the impression that companies which fail to comply precisely with the rule's requirements are prima facie engaging in market manipulative practices. The Committee believes that notwithstanding the attraction of the immunity concept, it would not be possible to devise workable rules for takeovers and non-takeover situations respectively. Instead directors and their advisers will have to exercise their own judgment to ensure they are not in breach of the market manipulation provisions.

Insider Trading

[16] Introduction of a self-purchase power may increase the opportunities for insider trading, both by the company and its insiders. There are two species of relevant insider information to consider:

* confidential knowledge that the directors have resolved to acquire the company's shares. (This would pertain particularly to the 10% of the company's shares which directors may purchase in any twelve month period without the prior authorisation of shareholders: see [54].)

* undisclosed information held by the company which is materially share price sensitive.

[17] With the former, the Committee would support applying the full force of the Securities Industry Code s128 to corporate "insiders" and "tippees". There is no distinction in principle between this situation and, say, knowledge by insiders of a company's intention to acquire shares of another corporation. The possibility of illegal gain from insider trading is not peculiar to self-purchases, rather it merely creates another avenue for its exercise. However this should

not suffice to preclude the company from trading and the Securities Industry Code s128(7A) should be amended accordingly.

[18] Where a company wishes to trade in its shares when in possession of undisclosed material price sensitive information, the Committee strongly favours application of the "disclose or abstain" principle. The potential for abuse arises from the unique knowledge a company may have concerning the value of its shares.

[19] The Committee recognises that application of the insider trading provisions in this context may impede a company's capacity to acquire its shares. However the prohibition on insider trading should be treated as paramount and any exemption for acquiring companies would fundamentally compromise that policy. Furthermore listed companies are already under an obligation to disclose any information which would be likely to materially affect the price of their securities: Australian Stock Exchange (ASX) Listing Rule 3A(1). Companies will have to balance the desirability of purchasing their shares against any commercial detriment involved in compliance with this legislation[3].

[20] In applying the insider trading provisions to acquiring companies, the Committee notes that in view of Hooker Investments Pty. Ltd. v Baring Bros. Halkerston Partners Securities Ltd. (1986) 4 ACLC 243, the wording of s128 may require some amendment.

3. The Committee notes the terms of NCSC Release 144 under which the Commission, in appropriate circumstances, will grant on exemption from the provisions of the Companies Code Part IV Division I (which relates to the public issue of securities) where, inter alia, "the company shall affirm to the public by way of notice to the ASX that ... it has complied fully with the requirement to keep the exchange fully notified of any information ... which would be likely to materially affect the price of [its] securities ... ": para 10(c). The Committee sees its recommendation on insider trading as consistent with the disclosure principle embodied in Release 144. However companies would not be required to make any active representation before acquisition; rather they would breach the Securities Industry Code s128 if they bought their shares while armed with undisclosed material price sensitive information.

Improper Attempts to Secure or Consolidate Corporate Control

[21] The Committee referred in the Discussion Paper to the possibility of directors utilising the self-purchase power to gain or maintain control of the company, or otherwise act in their own interests rather than for the company as a whole. The Committee considers that these potential abuses may be considerably lessened by:

* Application of common law and statutory (Companies Code s229) fiduciary obligations whereby directors must act in the interests of the company as a whole. Directors would breach the "proper purpose" aspect of their fiduciary duties if, in exercising their powers, their dominant or substantial object or purpose were to maintain themselves in management. (In Whitehouse v Carlton Hotel Pty. Ltd. (1987) 5 ACLC 421 at 426-27, the High Court indicated that it may suffice "if the impermissible purpose was causative in the sense that, but for its presence, the power would not have been exercised".) This fiduciary obligation is reinforced by the Committee's recommendation that shareholder authorisation of buy-backs not relieve directors of these duties: see [158].

* The limited inherent discretion given to directors to acquire the company's shares and the need for shareholder authorisation, based on full and complete disclosure, in all other instances: see [57]-[61].

[22] The Committee foreshadows that the powers and duties of directors may be further considered in a future Discussion Paper on Directors' Duties.

Greenmail

[23] The term "greenmail" in the context of self-purchases refers to the practice whereby the shares of a particular member are acquired by the company on the initiative of directors at a premium to market price, often in response to threats by that member to otherwise initiate a takeover bid or disrupt the company's affairs. The Committee takes the view that greenmail transactions are potentially detrimental to the interests of non-participating shareholders[4]. The Committee notes the problem of greenmail in overseas jurisdictions, particularly the USA, and would not wish to facilitate its use in Australia.

[24] The Committee believes that the problem of greenmail can be overcome by denying directors the power to make selective buy-backs (with limited exceptions: see [54]) and requiring authorisation by special resolution of members, excluding vendor shareholders and their associates. The Committee notes that in the USA greenmail attempts are being discouraged by adoption of company charter amendments requiring the consent of independent shareholders to selective premium price buy-backs. The Committee proposes that the principle of shareholder approval by special resolution for selective self-purchases be elevated to a general rule of law in Australia, regardless of price considerations.

4. The Committee made reference in the Discussion Paper [440] to a series of empirical studies which examined the overall impact of greenmail transactions on the welfare of non-participating shareholders. The Committee notes further studies in this area: Holderness C and Sheenhan D: "Raiders or Saviours?" Journal of Financial Economics Vol. 14 (lg85} 555-579; Mikkelson W and Rubark R: "Targeted Repurchases and Common Stock Returns" Massachusetts Institute of Technology 1986. See also Hartnett D: "Greenmail: Can the Abuses be Stopped7" Northwestern University Law Review Vol. 80 No 5 (1986) 1271-1318; Gordon J and Kornhauser L: "Takeover Defence Tactics: A Comment on Two Models" The Yale Law Journal Vol. 96 (1986} 295 at 311-320; Macey J: "Takeover Defence Tactics and Legal Scholarship: Market Forces Versus the Policymaker's Dilemma" The Yale Law Journal Vol. 96 (1986) 342-352.

Increasing the Risk of Corporate Failure

[25] All self-purchase transactions involve the distribution of corporate assets to shareholders, and to that extent increase the financial risk to creditors and remaining shareholders. Buy-backs appear to reverse the priorities between creditors and shareholders while simultaneously reducing the company's margin of financial viability.

[26] The Committee believes that the rights of creditors and remaining shareholders may best be protected by prohibiting a company from entering into buy-backs unless the requisite solvency requirements are satisfied, with the imposition of joint and several personal liability on directors in the event of breach of these requirements: see [86]-[92].

[27] The Committee also points out that creditors may protect themselves by restrictions in debt covenants. Debenture trust deeds and other financing instruments already require companies to maintain a stated balance between assets and liabilities, and these deeds may be employed to restrain the company from buy-backs detrimental to creditors.

PART II: IMPLEMENTING THE SELF-PURCHASE POWER

Procedural Perspective

[28] Part II of this Report examines the procedural policy issues that would arise with the adoption of a self-purchase power in Australia. It raises a number of complex yet critical questions for consideration. In addressing these matters, the Committee was conscious of the need to achieve a balance between necessary protective regulation and the avoidance of excessive procedural prescription. The Committee sought to evaluate implementation issues and options by reference to its General Aims, namely, to develop proposals for laws:

* which are practical in the field of company law and securities regulation;

* which facilitate, consistently with the public interest, the activities of persons who operate companies, invest in companies or deal with companies and of persons who have dealings in securities; and

* which do not increase regulation beyond the level needed for the proper protection of persons who have dealings with companies or in relation to securities.

This Part follows the format of Chapter 5 of the Discussion Paper.

The Ambit of the Self-Purchase Power

[29] The statutory prohibition on self-purchases is found in the Companies Code s129. Three categories of prohibited transactions are involved:

* a company directly or indirectly acquiring its own shares or units of shares: s129(1) (b) (i);

* a purported direct or indirect acquisition by a subsidiary company of shares or units of shares in its holding company: s129(1) (b) (ii); s36(1) (2); and

* a company directly or indirectly lending money on the security of its shares or units of shares in itself or its holding company; s129(1) (c).

[30] The expression 'unit' of shares is defined in the Companies Code s5(1) as:

"any right or interest, whether legal or equitable, in the share ... by whatever term called, and includes any option to acquire any such right or interest in the share".

[31] Each of these prohibitions requires separate consideration.

Section 129(1) (b) (i)

[32] "Directly or indirectly": The Committee believes that in the interests of full disclosure and avoidance of market manipulation, all self-purchases should be in the name of the acquiring company, and that the existing prohibition on 'indirect' acquisitions, e.g. through associates or nominees: Re Galpin (1967) 11 FLR 155, be maintained.

[33] "Shares": For the reasons set out in Part I of this Report, the Committee favours the repeal of this sub-section as it applies to shares, thereby allowing companies to directly acquire these securities, subject to compliance with the procedural requirements proposed in Part II of the Report.

[34] "Units of shares": Companies should be entitled to acquire options over their unissued shares and redeem their convertible notes before maturity: see [102]-[104]. However the Committee would not recommend lifting the prohibition on companies acquiring equitable rights in their issued shares.

This restriction is necessary to ensure against companies circumventing the cancellation requirements for self-purchases: see [105].

Section 129(1)(b)(ii)

[35] The Companies Code s36 prohibits subsidiary companies from being shareholders of their holding companies. There are valid reasons for maintaining this prohibition independently of buy-back considerations e.g. to prevent directors of parent companies entrenching their position by controlling the voting power of subsidiaries who are members of the parent company: Bond Corporation Pty. Ltd. v White Industries Limited (1980) 5 ACLR 88 at 97; Comeng Holdings Ltd. v CAC (1984) 2 ACLC 87. Accordingly the Committee would not favour subsidiary companies being permitted to purchase shares or units of shares in their holding companies.

Section 129(1) (c)

[36] This provision, inter alia, reinforces s129(1) (b) by preventing circumvention of the self-purchase prohibition under an arrangement whereby a company lends money on the security of its shares, a legitimate or engineered default in repayment occurs, and the company exercises its right to enforce the security, which, conceivably, could include acquiring its shares.

[37] The Committee considers that s129(1)(c) should continue to prevent that circumvention. It is possible that without the prohibition parties may enter into mortgage transactions for the purpose of avoiding the procedural restrictions on selective self-purchases: see [54]; [57]-[61]; [73]-[74].

[38] In applying this sub-section to parent companies, the same comments hold as under s129(1)(b)(ii) and the Committee would not support abolition of this statutory prohibition.

The Structure of the Self-Purchase Power

[39] In determining the most suitable procedures to govern the exercise of the self-purchase power, the Committee considered the merits of adopting the Companies Code s129(10)-(17) and s130, thereby treating self-purchases and financial assistance transactions in an identical manner. The Committee concluded that despite the attraction of uniformity in this approach, there were sufficient material differences in these transactions to require their disparate treatment:

* Financial assistance transactions commonly involve the company funding particular individuals, whereas self-purchases may be effected through on-market acquisitions or pari passu offers which provide all shareholders with the opportunity to participate. This would justify a less stringent shareholder authorisation procedure for these self-purchases (though not selective self-purchases) vis-a-vis financial assistance transactions.

* Self-purchases unlike financial assistance transactions, may take place in the public market, thereby necessitating procedural rules that reflect market requirements and practices.

* To apply the complex financial assistance validation procedure (under s129(10)-(12)) to all self-purchases may considerably slow down the self-purchase process and undermine the benefits of its introduction, given the present capacity of companies to reduce their issued share capital by special resolution and court order pursuant to the Companies Code s123: (e.g. Re Tantalex Ltd. (1987) 5 ACLC 266).

[40] For these reasons the Committee favours discrete procedural rules for self-purchases.

[41] Some of the major differences between s129, s130 and the procedural rules for self-purchases proposed by the Committee are here summarised:

Source of the self-purchase power

* A company may purchase its shares only if authorised by its Memorandum or Articles. There is no equivalent provision for financial assistance transactions.

Authorisation Procedure

* Directors will have a limited initiative to acquire their company's shares by on-market or pari passu purchases. There is no equivalent power with financial assistance transactions.

* Shareholders may authorise further on-market or pari passu self-purchases by ordinary resolution. Selective self-purchases, as with financial assistance transactions: s129(10), will require a special resolution.

* Shareholders will be required to settle the terms of their authorisation. There is no equivalent under financial assistance transactions.

Appeal Procedures

* There will be no specific appeal procedures applicable to self-purchases. This contrasts with the statutory procedures applying to financial assistance transactions: s129 (12) (13).

Consequences of Irregular Authorisations

* Self-purchase transactions shall be deemed valid notwithstanding any breach of the procedural

requirements. This contrasts with the voiding and certification procedures for financial assistance transactions: s130.

Market Disclosure

* Self-purchases shall be subject to more detailed disclosure requirements than those pertaining to financial assistance transactions: s129(10) (h).

[42] In addition there are certain regulatory requirements for self-purchases that do not apply to financial assistance transactions, e.g.:

* the status of self-purchases;
* accounting for self-purchases;
* substantial shareholding implications.

[43] Finally there are various rules applicable to financial assistance transactions which the Committee considers are inappropriate or unnecessary in the context of self-purchases; e.g.:

* approval by the holding company: s129(10) (b);
* notice to trustees/debenture holders of the company: s129 (10) (f) (g).

Source of the Self-Purchase Power

[44] The Discussion Paper identified differing ways in which to frame the self-purchase power in the legislation, in increasing degree of restriction:

* an inherent power;
* a power, subject to any contrary statement in the Memorandum or Articles; or
* a power only if stipulated in the Memorandum or Articles (with or without a "sunset" provision).

[45] The Committee takes the view that as buy-backs have the potential to alter significantly the pattern of shareholding as well as financial structure of a company, the self-purchase power should exist only when members have specifically assented to it. To provide companies with an inherent self-purchase capacity would be inconsistent with that principle. The third option, a power only if contained in a company's constituent documents (Memorandum or Articles of Association), either upon incorporation or by subsequent special resolution, provides for maximum shareholder protection in this regard. It puts subscribers to the Memorandum and other members on notice and allows them the opportunity to consider and vote on whether the company should have the buy-back power in the first instance. It is consistent with the approach taken in s120(1); s121(1) and s123(1) of the Companies Code, and accords with the self-purchase provisions of the UK Companies Act s162(1). By contrast the second option, a right, subject to any contrary statement in the Memorandum or Articles, automatically grants the power unless shareholders pass a special resolution for its prohibition.

[46] In supporting the third option, the Committee suggests that self-purchases be identified as a corporate legal power under the Companies Code s67(1).

Nature of the Special Resolution

[47] The function of this restriction in the grant of power is to enable shareholders to determine, in principle, whether the company will have a buy-back capacity. However, the authorisation procedure for exercise of the power, once granted, should, in the interests of certainty and uniformity, be prescribed by statute. A special resolution that purports to introduce other or additional authorisation requirements, should, in respect of those terms only, be void and have no effect.

Sunset Provision

[48] The Committee considered whether a self-purchase power should be subject to a "sunset" provision whereby it would lapse unless renewed every three years by special resolution: cf CASA s31B(2)(3). The Committee believes that the same considerations here apply as with the partial bid shareholder plebiscite sunset provision, namely that the composition of members may be continually changing (particularly listed public companies) and it is the binding of successors which is of particular concern[5]. A sunset provision would not be unduly burdensome and would periodically reinforce the principle that shareholders decide whether their company should have a buy-back capacity.

Notice of Special Resolution to Introduce or Renew the Self-Purchase Power

[49] To ensure that shareholders are fully informed on the purpose and implications of including or renewing a buy-back power in the constituent documents of the company, the legislation should require that the Notice of meeting specifying the intention to propose the special resolution shall:

* explain the reasons for proposing the resolution and set out any factual matters and principles underlying those reasons;

* discuss both the potential advantages and disadvantages of a buy-back power for the company, its directors and shareholders respectively; and

* (with renewal) review the exercise of the power in the period since the last special resolution and its effects on the company, the directors and shareholders respectively.

5. Refer: CSLRC Report to the Ministerial Council on Partial Takeover Bids (August 1985) para [89].

Authorisation Procedure

[50] As indicated in the Discussion Paper, the procedure for enabling a company to purchase its shares (given the necessary power in the constituent documents) raises a number of inter-related policy issues:

* who should be authorised to exercise the power;
* what information should be provided to the decision-makers;
* what should be the terms of any authorisation;
* what appeal procedures should lie from the authorisation, and
* what should be the consequences of an irregular authorisation.

Persons Authorised

[51] In determining who should be entitled to exercise the company's self-purchase power, the Committee raised the following options in the Discussion Paper:

* by such person or persons as authorised by each company at its discretion,
* by ordinary resolution of the directors,
* by super majority resolution of directors,
* by ordinary resolution of shareholders, or
* by special resolution of shareholders.

[52] Some respondents favoured granting company directors the exclusive authority to exercise the self-purchase power, once contained in the company's charter. It was argued that "it is a fundamental precept that a company should be managed by its directors and not through the general meeting", and that this maxim should be reflected in the buy-back procedure. Other submissions supported prior shareholder authorisation of each buy-back transaction, thereby providing maximum protection to

members against possible abuse, particularly with selective buy-backs. An intermediate position taken by some respondents was that directors should have a limited buy-back power as of right, with further acquisitions requiring shareholder consent.

[53] The Committee took various factors into account in determining the most suitable authorisation procedure:

* The workability and effectiveness of the procedure - for instance, shareholder involvement consumes more time and costs than when the power resides in directors.

* The merits of adopting differing authorisation procedures depending upon the method of purchase. A more restrictive procedure may be suitable for selective buy-backs, given the possibility of internal inequities or greenmail, than for on-market or pari passu purchases, where the dangers of these abuses are much reduced.

* Existing statutory constraints on abuse by directors of any buy-back power exercised by them e.g. Securities Industry Code Part X; Companies Code s229; s320; s574.

[54] Given these considerations, the Committee recommends that the following rules apply to all companies adopting the self-purchase power.

* With on-market and pari passu purchases, directors shall be entitled to acquire up to 10% of the company's capital in any twelve month period without prior shareholder authorization. The 10% figure shall be calculated by reference to the number of issued shares at the commencement of the twelve month period, i.e. when the directors make their initial acquisitions cf. ASX Listing Rule 3E(6) (a). Thus if a company has

an issued share capital of ten million shares at the date of initial acquisition, the directors may acquire up to one million shares in the immediate twelve month period without resort to shareholder authorisation. The limit of one million shares would remain throughout the period, notwithstanding that the company may, during that time, increase its issued share capital.

* With on-market and pari passu purchases in excess of this 10% figure, the prior consent of shareholders by ordinary resolution shall be required.

* With selective self-purchases, (other than odd lot purchases or shares acquired pursuant to an employee share scheme), the prior approval of shareholders by special resolution, excluding the votes of the proposed vendor and the vendor's associates shall be required. The Committee believes that a special resolution is necessary to counter possible irregularities: see [73]-[74]; [97]-[99].

* A "de minimis" exception should be allowed for "odd lot" transactions for listed public companies whereby the directors may, without shareholder approval, acquire in the aggregate odd lots of up to .1% of the company's shares in any twelve month period by selective buy-backs.

* A separate provision should be included for employee share schemes empowering directors to buy-back listed or unlisted shares from the original allottee, pursuant to self-purchase and pricing terms of schemes previously approved by general resolution of shareholders: cf. Companies Code s129(9) (b).

[55] The Committee believes that these rules should be contained in the Companies Code rather than Stock Exchange Listing Rules, given that they will apply to both listed and unlisted companies.

Information to the Decision Makers

Directors

[56] Where the buy-back power rests exclusively in the hands of directors, they will have access to the necessary information and statutory disclosure requirements will be unnecessary. Directors must satisfy themselves as to the solvency of the company: see [87]-[88].

Ordinary and special resolution of shareholders

[57] Where exercise of the buy-back power by directors requires the prior consent of shareholders by ordinary resolution (on-market and pari passu purchases in excess of 10% in any 12 month period) or special resolution (selective self-purchases other than "de minimis" odd lot and employee share scheme acquisitions) members must be able to make a fully informed decision. To ensure that directors comply with a 'complete candour' standard of disclosure, the Committee favours a statutory requirement that the Notice of shareholder meeting to authorize the self-purchase set out specific information.

[58] Disclosure requirements common to an Ordinary and Special Resolution Notice:

* the reasons for the proposed self-purchase and the names and stated reasons of any directors who voted against the resolution of directors proposing the self-purchase;

* a statement whether any of the directors is aware of a proposal by any person to acquire, or increase, its substantial shareholding interest in the company, or undertake a takeover bid;

* the anticipated financial consequences to the company of the self-purchase, including a declaration of solvency by directors supporting the proposal: see
[873;

* any other information material to the making of a decision by the shareholders whether to authorize the self-purchase, which is within the knowledge of any director.

[59] Additional disclosure requirements for an Ordinary Resolution Notice (on-market and pari passu purchases):

* detailed information on the terms of any proposed buy-back programme;

* the intention of each director and any associates whether to sell their shares to the company;

[60] Additional disclosure requirements for a Special Resolution Notice (selective self-purchases):

* a summary of the material terms of the proposed selective self-purchase contract and a statement that the contract is available for inspection by members of the company both at the company's registered office, at least fourteen days before the date of the authorisation meeting and at the meeting itself;

* where the consideration offered by the company is in a non-cash form or contains a non-cash element or

alternative, a statement by directors as to its equivalent cash value[6];

* the nature of any association between the vendor and/or its associates, and the company directors (including the content of any relevant declarations under the Companies Code s228);

Fiduciary obligations

[61] These Notice requirements for ordinary and special resolutions would be in addition to the common law fiduciary obligations of directors arising from company general meetings[7].

Substantial compliance

[62] The Committee considered the merits of including a "substantial compliance" provision to deal with minor procedural irregularities: cf. Companies Codes s129(11); Re U Drive Pty. Ltd. (1987) 5 ACLC 117. The Committee concluded that this provision may be unnecessary in the context of self-purchases, given the recommendation that all completed irregular buy-backs be deemed valid rather than void or voidable: see [77]-[80], and the ambit of the Companies Code s539.

Terms of the Authorisation

On-market and pari passu purchases

[63] Where exercise of the buy-back power requires prior shareholder approval by ordinary resolution, the Committee

6. The Committee favours applying the same valuation requirements to selective non-cash self-purchases that it proposes for non-cash share issues: see CSLRC Report to the Ministerial Council on the Issue of Shares for Non-Cash Consideration and Treatment of Share Premiums September 1986 paras [7] - [12]. The statement by directors would follow the format proposed in para [12].

7. See E. Magner: "Notice of Purpose of Company General Meetings: the Common Law Requirement, the Fiduciary Duty" Company and Securities Law Journal Vol. 5 (1987) 92-108.

considered what directions, if any, members should give directors over the exercise of the power. The European approach, as set out in the EEC Second Directive, and reflected in the UK Companies Act s164-166, provides that the general meeting "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 authorisation is given which may not exceed eighteen months, and in the case of acquisitions for value, the maximum and minimum consideration".

[64] One submission sought to exclude any mandatory authorisation terms, arguing that, given their potential latitude, they may have little effect. For instance, the stipulated maximum and minimum consideration requirements could be drawn so widely as to provide no real guidance or control.

[65] The Committee recognises the possibility of such latitude being given, but nevertheless considers it advantageous to adopt the EEC approach. Mandatory criteria provide a useful guide to shareholders in considering proposed self-purchases, while leaving them with a degree of flexibility in regulating the buy-back process, without unduly restricting its everyday exercise.

[66] In summary the legislation should require that shareholders, in authorising on-market or pari passu self-purchases, stipulate:

* the maximum number of shares to be acquired;

* the method of buy-back i.e. whether on-market and/or pari passu;

* any minimum time period for which a company, having embarked upon a buy-back, must either 'stand in the market' (for on-market acquisitions, subject to purchase of the stipulated maximum number of shares) or hold open the pari passu offer;

* the maximum and minimum prices which may be paid for the shares, by statement of a particular sum or adoption of a formula;

* a specific time period for which the buy-back authority is effective, not exceeding eighteen months from the time of the resolution;

[67] The authority may be otherwise unconditional or subject to further stipulated conditions. It may be general, or limited to the purchase of shares of a particular class or classes or description. However no authorization may oblige directors to acquire shares if they are not satisfied as to the solvency of the company: see [87]. Furthermore shareholder authorisation should not relieve directors of their fiduciary or statutory obligations cf Companies Code s129(15). For instance, it should be no defence to an action against directors for market price manipulation (Securities Industry Code s123; s124; North v Marra Developments Ltd. (1981) 37 ALR 341) that shareholders authorised the price paid.

[68] The Committee would favour a further statutory provision that any authorisation given by shareholders may be revoked or amended, in futuro, by ordinary resolution. This would allow shareholders to revise an authorisation, for instance where there is a change in the company's financial position, shareholding control or composition of the board of directors.

Authorisations and the Sunset Provision

[69] The Committee has recommended that the self-purchase enabling provision be subject to a sunset requirement, whereby it will lapse after three years, unless renewed by further special resolution: see [48]. It is possible that a company's self-purchase power may lapse (through failure to renew the power) during the course of a buy-back programme previously authorised by shareholders. The Committee considers that the

function of the sunset provision is to regulate a company's future buy-back capacity, not to interfere with valid authorisations given under previously existing Articles or Memorandum terms. Directors should retain the right to acquire shares pursuant to an outstanding authorisation, notwithstanding lapse of the enabling provision.

[70] Likewise shareholders should remain entitled to revoke any outstanding valid authorisation. However, application of the sunset provision would prohibit any further shareholder authorisation or any acquisition solely at the initiative of directors.

Status of Prior Authorisations

[71] The function of the shareholder authorisation procedure is to enable directors to acquire shares within a stipulated future period. There may be an overlapping of authorisations whereby shareholders are asked to approve a buy-back programme where a previous, but still operative, authorisation has not been fully utilised. In these circumstances the following policy options are available:

* treat each shareholder authorisation in isolation, thereby allowing for an accumulation or "stacking" of authorisations;

* adopt the first option, but subject to disclosure by directors of any unutilised buy-back capacity in advance of any further authorisation; or

* provide that each authorisation automatically cancels any prior ongoing authorisation.

[72] The Committee was concerned that the first option may allow directors to increase significantly their buy-back capacity without this being fully appreciated by shareholders.

The second option addresses this problem, but in a less direct and simple manner than the third option which best ensures that shareholders are cognizant of the precise terms and implications of any authorisation. For these reasons the Committee favours automatic cancellation of any outstanding authorisation.

Selective Self-Purchases

[73] The Committee considers that selective acquisitions require close regulation, given their potential for generating greenmail or shareholder inequities. Companies should be prohibited from selectively acquiring their shares (with limited exceptions) without the prior consent of non-participating shareholders by special resolution: see further [97]-[99]. However members may not compel directors to selectively purchase shares in breach of the solvency requirements: see [87].

[74] The principle of shareholder approval might be fundamentally compromised if members were permitted to grant directors a discretionary in futuro power, similar to on-market or pari passu authorizations. Rather, the specific consent of shareholders by special resolution should be required for each selective buy-back transaction: cf NCSC v Consolidated Gold Mining Areas N.L. (1985) 3 ACLC 424; 520. This obligation is reflected in the Notice requirement that shareholders receive a summary of any proposed selective purchase contract in advance of the authorization meeting: see [60].

Appeal Procedures from Authorisations

[75] The Discussion Paper set out various possible appeal procedures from the exercise of the self-purchase power:

* reliance on existing statutory appeal provisions, with no separate appeal structure for buy-backs;

* a specific self-purchase appeal structure for all buy-backs; or

* a limited specific appeal structure e.g. from shareholder authorisations.

[76] The Committee believes that to provide a specific appeal structure for all or some self-purchases may be too restrictive and cumbersome and could lead to unreasonably protracted delays. The Committee referred in the Discussion Paper:
[5016] to a possible appeal structure modelled on s129(12) (13) being used for tactical reasons in the context of a contested take-over bid. Instead the Committee would favour reliance upon the existing statutory grounds of challenge against the actions of directors or shareholders (e.g. Companies Code s229; s320; s574) and recommends that there be no further appeal provisions specifically directed to self-purchases. The interests of creditors and shareholders would further be protected by solvency requirements: see [86]-[92].

Consequences of Irregular Authorisations

Status of Affected Transactions

[77] The Committee considered whether completed self-purchase transactions in breach of the procedural requirements should be:

* void
* voidable, or
* valid.

[78] The Committee was concerned that to treat irregular on-market or pari passu completed transactions as either void or voidable may be detrimental to bona fide vendors and create undue market uncertainty. The Committee would not support applying the Companies Code s130(2)-(5) to these acquisitions

(whereby they would be voidable at the option of the company). The preferred course is to deem all irregular on-market and pari passu transactions valid: cf CASA s11(5).

[79] The Committee considered whether there may be a stronger case for adapting the terms of s130(2)-(5) to completed selective self-purchases, given the possibility of greenmail or internal inequities. If this approach were adopted the interests of bona fide vendor shareholders could be protected by employing a certification procedure similar to financial assistance transactions: s130(6)-(10).

[80] The Committee prefers a uniform policy for all irregularly authorized completed self-purchases. A differentiation between selective and non-selective acquisitions could be confusing and, from the perspective of bona fide vendor shareholders, unjustifiable. Furthermore the likelihood of selective self-purchases generating greenmail or other irregularities is greatly diminished by the more restrictive authorization procedures proposed: see [73]-[74]. For these reasons the Committee concludes that all completed transactions, including selective buy-backs, made on the basis of irregular authorisations should be valid. Criminal and/or civil liability arising from such transactions may fall upon the directors and any other persons who were knowingly parties to an irregularity: see [155]-[159].

Financial Considerations

[81] A self-purchase transaction involves the distribution of corporate assets to vendor shareholders and to that extent increases the financial risk to creditors and remaining shareholders. Imprudent use of a self-purchase power could so deplete a company's assets as to lead to insolvency, or seriously lessen its margin of financial viability. Given this

problem, the Committee mooted in the Discussion Paper two means of lessening this risk:

* restrictions on the sources of funds available for self-purchases; and/or

* imposition of solvency requirements on self-purchases.

Source of Funds

[82] The Committee considered what restrictions, if any, should be placed on the fund sources. For instance, the UK legislation limits the available funds to:

* profits otherwise available as dividends;

* proceeds of a fresh issue of shares made for the purpose of the self-purchase; and

* capital (private companies only and in limited circumstances).

[83] By contrast the North American statutes generally impose no restrictions on the source of available funds, thereby allowing companies to finance buy-backs in the same manner as other commercial transactions, though subject to stipulated solvency requirements.

[84] The Committee believes that it would unnecessarily complicate the buy-back process to introduce a source of funds requirement, and notes that no similar restrictions apply to financial assistance transactions: Companies Code s129(10). The key factor is the overall financial health of companies and not the sometimes arbitrary distinctions between various sources of funds. The Committee is also aware that the generally permissive common law rules for identifying profits otherwise available as dividends may afford only limited

control over self-purchases. The interests of creditors and remaining shareholders could be more directly protected by imposing a solvency requirement on buy-backs.

[85] The Committee also considered whether the lack of fund source restrictions could lead to companies utilising their buy-back power in a potentially improper manner, e.g. funding a defensive self-purchase programme in whole or in part by the issue of shares to "white knights". However, there are existing constraints on such actions:

* the common law and statutory fiduciary duties applicable to directors in the exercise of their powers, including share issues, e.g. Whitehouse v Carlton Hotel Pty. Ltd. (1987) 5 ACLC 421;

* the limited capacity of directors to acquire shares without the prior consent of shareholders (10% in any twelve month period).

Solvency Requirements

[86] The Committee strongly favours the inclusion of solvency requirements for self-purchases to protect creditors and remaining shareholders.

The Declaration of Solvency and Personal Liability

[87] The Committee proposes that the legislation impose on non-dissenting directors an obligation to make a declaration of solvency both at the time of authorisation by shareholders: see [58], and as a prerequisite to their entry into buy-backs. This declaration must state that the directors (other than those who recorded their dissent from the solvency declaration) have made inquiry into the affairs of the company and, after taking into account the excess of the realisable value of the company's assets over its current and contingent liabilities,

have formed the opinion that the company will be able to pay its debts as and when they fall due over the next six month period cf Companies Code s395(1). In the event that the company becomes insolvent, the non-dissenting directors shall be personally liable, jointly and severally, to compensate the company for the total funds expended on self-purchases in the six months prior to insolvency. Given this potential liability, directors should be entitled to refuse to enter into buy-back transactions if they are not satisfied the company is solvent, regardless of any direction that shareholders may seek to include in their terms of authorization.

[88] The Committee believes that it may be too harsh to impose strict civil liability on directors. They should be relieved of personal liability wherever they establish that at the time of making the relevant declaration they had reasonable grounds for the solvency opinion cf Companies Code s395(5).

Recording the Declaration of Solvency: The Deeming Provision

[89] The Committee considers it necessary that a declaration of solvency apply to all self-purchases. In theory the preferred course would be for directors to formally record the declaration prior to each buy-back transaction. However this would be unduly cumbersome, given that shares may be acquired on-market or pari passu on a continuing basis over an extended period. The Committee favours, as a practical solution, a statutory provision whereby a formally recorded declaration would have a subsequent life of six months and be deemed to apply to each transaction within that period, unless or until a further declaration was made. This deeming provision would obviate the need to formally record the declaration of solvency in the directors' minutes prior to each acquisition. However it would not lessen the potential personal liability of directors, who would remain under a continuing obligation

to satisfy themselves as to the solvency of the company[8]. Furthermore the deeming provisions would not relieve directors of existing statutory obligations arising from the making of declarations. For instance, the legislation should make clear, that the false declaration provisions of the Companies Code: s563(2) (2A) (3) (3A) shall apply as if there were a formal declaration of solvency each time the buy-back power was exercised.

Who Should Make the Declaration of Solvency

[90] The Committee believes that ultimate responsibility for the solvency declaration should rest with directors, not the shareholders or company auditors. The Committee does not favour the UK approach whereby as a pre-requisite to a solvency declaration (required for buy-backs by private companies out of capital) an auditor's report must accompany the directors' report. This dual obligation may be too onerous if applied to all Australian companies.

Lodging the Declaration of Solvency

[91] The legislation should require that any formal declaration of solvency be lodged with the Commission cf. Companies Code s129(10)(e).

Application to a Court Concerning the Solvency Declaration

[92] One respondent favoured permitting directors, at the time of a formal or deemed declaration, to seek a court ruling that the required solvency tests had been satisfied. This

8. For example: the directors make a formal declaration of solvency on the 1st January, the company acquires its shares on 1st May without a further formal declaration and the company goes into insolvent liquidation on 1st September of that year. Under the deeming provision, directors shall be taken to have made a declaration of solvency on the 1st May. This being within six months of the insolvency, personal liability would attach, subject to the "reasonable grounds" defence.

approach, if adopted, would allow directors to rely on a court declaration of solvency to avoid possible civil liability arising from buy-backs. The Committee considers that it would be beyond the role and function of the court to make these determinations and would not support this provision. However the Committee notes the terms of the Companies Code s535 and s539 which, in relevant cases, may afford relief to directors from personal liability. These provisions stand in addition to the "reasonable grounds" defence proposed by the Committee.

Method of Purchase

[93] The Discussion Paper set out five possible avenues by which a company might purchase its shares:

* on-market acquisitions
* off-market pari passu offers
* off-market tender offers from shareholders
* mandatory acquisitions
* selective (privately negotiated) purchases.

On-market acquisitions

[94] There was strong support in the submissions for allowing companies to purchase shares by on-market acquisitions. This would involve a company buying its shares through a broker at an official meeting of the Stock Exchange in the ordinary course of its business. To ensure that companies could not effect 'back door' selective self-purchases, special crossings[9] would not be allowed. The Committee favours a further requirement that to facilitate a fully informed market all on-market buy-backs take place on the Home Exchange of the acquiring company.

9. ASX Business Rule 2.6(11A); cf CASA s8(9).

Pari passu offers

[95] The Committee takes the view that the same principles should apply to pari passu offers as with partial bids under CASA, namely that the company must offer to purchase a fixed percentage of each shareholder's shares (rounded off to avoid odd lots). Companies should be prohibited from discriminatory buy-backs, whereby one or more shareholders are barred from participation in the pari passu offer: see Discussion Paper [330][10]. Also the Committee would not favour allowing companies to pro rata excess tendering where some shareholders decline the proportional offer. This could introduce coercive pressures similar to pro-rata partial bids[11]. The principle of equal opportunity would be better served by the company making a further on-market or pari passu offer.

Off-market tender offers from shareholders; mandatory acquisitions

[96] There was no support in the submissions for either off-market tender offers from shareholders: (Discussion Paper: [5045]) or mandatory acquisitions: Discussion Paper [5049] - [5050]. The Committee does not believe that either buy-back method would be suitable for Australia and accordingly would not support their introduction.

Selective (privately negotiated) purchases

[97] The Committee recognised in the Discussion Paper that there may be valid commercial reasons for a company wishing to enter into buy-back agreements with particular shareholders. However, selective purchases create the potential for greenmail and other irregularities. Given this, the Committee

10. In July 1986 the US Securities and Exchange Commission adopted an "All Holders" rule which prohibits discriminatory issuer self-tender offers in that country; SEC Release Nos. 33 - 6653, 34 - 23431. See generally Herzel L and Shepro R; "The Changing Fortunes of Takeover Defences" Securities Regulation Law Journal Vol. 15 (1987) 116 at 118-121.

11. CSLRC Report to the Ministerial Council on Partial Takeover Bids (August 1985).

considered two options:

* limiting the circumstances in which selective self-purchases may be made; or

* imposing a restrictive authorisation procedure.

[98] The Committee opposes the first option in that it may be impossible to determine in advance a suitable range of permitted categories. Furthermore this option would not necessarily overcome the possible abuses of selective buy-backs within these permitted categories.

[99] Under the second option, the Committee considered whether selective self-purchases (other than odd lot or employee share acquisitions: see [54]) should require an ordinary or special resolution of members (excluding vendor shareholders and their associates). A special resolution would provide shareholders with maximum protection against greenmail and other procedural irregularities, while still permitting companies to engage in selective buy-backs if approved by sufficient shareholders. This requirement would be consistent with the UK approach (Companies Act s164) and the terms of the Companies Code s129(10) (given that financial assistance transactions, like selective self-purchases, involve the company dealing with particular individuals rather than shareholders as a whole). The Committee was also concerned that certain shareholders may derive significant and possibly unjustified advantage under an ordinary resolution requirement[12]. The Committee therefore favours a special resolution as a prerequisite to a selective self-purchase.

12. The Committee poses the hypothetical example of a listed public company with two major shareholders; A, a director, holding 30% and B, a director, holding 25% of the total issued voting shares. B wishes to relinquish his shareholding and A wants to maintain his shareholding dominance. In these circumstances A could acquire up to 3% of B's shares (CASA s15), undertake a formal bid, or seek to acquire B's shares pursuant to CASA s12(g). The disadvantages to A are that he could not limit his bid to B's shares and, being the purchaser, would be excluded from voting on a s12(g) resolution. By contrast A, (unless an associate of B) could vote on a resolution that the company acquire these shares by selective self-purchase and could more easily carry an ordinary than a special resolution authorising the transaction. The buy-back would increase A's proportional shareholding from 30% to 40% of the company's issued share capital (given that B's shares are cancelled) without cost to A.

Types of Self-Purchases

Partly-paid shares

[100] The Committee raised the question in the Discussion Paper whether only fully-paid shares should be capable of acquisition. The argument against including partly paid shares is that creditors could be disadvantaged since uncalled capital represents a potentially valuable asset available to creditors in the event of corporate default. However, creditors are already protected in that directors are personally liable for funds expended on buy-backs within six months of insolvency: see [87]. This may be a sufficient remedy if liability extends to the value foregone as well as the value paid in the transaction. Also any prohibition could be easily circumvented e.g. by the company agreeing to buy the shares at a premium to par or market value once fully paid, the premium being equal to the amount outstanding on the shares (e.g. $1 shares paid to 60c, to be acquired by the company at $1.40 if fully paid).

[101] In summary the Committee believes that partly-paid shares should be capable of acquisition but that the potential liability of directors in the event of insolvency include both the consideration paid by the company and any amount unpaid on those acquired shares.

Options and Convertible Notes

[102] Various submissions raised the question whether options and convertible notes should be capable of acquisition.

[103] The Committee notes that at present companies may, by contract, redeem convertible notes before maturity or conversion, and sees no reason to alter this practice.

[104] As regards options over unissued shares, the Committee notes the argument that in view of the definition of "unit" of shares: Companies Code s5(1), the existing s129(1)(b) prohibition may not apply to these buy-backs. Whatever may be

the correct interpretation of these provisions, the Committee believes that, in principle, companies should have the power to purchase options over their unissued shares, free of the procedural requirements recommended for self-purchases, other than:

* (with listed companies) to inform the market by 9.30 a.m. on the next trading day: see [122]

* to observe the general common law controls over improper disposition of company funds (e.g. directors' fiduciary duties) and the solvency requirements for self-purchase: see [86]-[92]

* to cancel the acquired options forthwith: see [127]

* to adjust the register of options accordingly: Companies Code s131 and enter the details on the self-purchase register: see [122].

[105] The Committee would not support companies acquiring options over their issued shares. This would allow companies to gain a beneficial interest in their shares and would be inconsistent with the principle that all self-purchased shares must be cancelled: see [127]. Such trading may also be potentially too manipulative, given the leverage effects of these transactions.

Volume of Self-Purchases

Minimum Membership Requirements

[106] Australian companies, except for certain wholly-owned subsidiaries, must have a minimum membership of two shareholders (proprietary companies) or five shareholders (public companies): Companies Code s82. This section imposes civil liability on remaining members in the event of continuing breach of these requirements. The Committee sees this

provision as adequate to regulate minimum membership requirements and considers it unnecessary to include any separate provision prohibiting self-purchases in breach of this section.

Maximum acquisitions within a given period or as a proportion of the company's share capital

[107] The Committee gave close consideration to the possible introduction of a rule drawn from US SEC Rule 10b-18, which places volume (as well as price and timing) constraints on buy-backs. This rule prevents acquiring companies dominating the market turnover and hence the price of their shares. However, for reasons outlined previously, the Committee does not recommend its adoption: see [14]-[15].

[108] The Committee also considered adoption of the London Stock Exchange rule prohibiting a listed company from buying 15% or more of its shares within any 12 month period, except by way of a general or partial offer to all shareholders. A restriction of this kind appears unnecessary given shareholder control over large scale or selective self-purchases: see further [54].

Price Regulation

[109] As previously indicated, the Committee does not support a price control mechanism similar to Rule 10b-18, (which limits the self-purchase consideration to the higher of either the highest current independent bid price or the last independent sale on the Exchange). Furthermore the Committee believes that the London Stock Exchange Rule regulating self-purchase consideration (that the buying price must be no more than 5% above the average of the middle market quotation in those shares in the ten business days prior to the purchase) is unworkable in a volatile market or during the course of a takeover bid. Instead the shareholders of the company, pursuant to the authorisation procedure, can determine the maximum consideration to be paid by the company.

Timing of Acquisitions

[110] For reasons given previously, the Committee does not favour the introduction of US Rule 10b-18 (which prohibits self-purchases on any given day until there has been an independent transaction in those shares and during the last half hour of trading on the Exchange) and would not place a timing restriction on self-purchases, other than an advance disclosure retirement: see [112]-[121].

[111] The Committee also considered the London Stock Exchange Rule prohibiting self-purchases in the two months immediately preceding the announcement of a company's annual or half yearly results. The rule is designed to discourage companies from either engaging in insider trading or intentionally or inadvertently arousing market speculation as to the asset value backing of their shares. It appears to the Committee that this rule may not be suitable for Australia, particularly in the context of takeover bids, where offerors may be advantaged by the simple expedient of mounting a bid in these periods. Furthermore, the insider trading and other market manipulation provisions of Part X of the Securities Industry Code would regulate a company's behaviour.

Advance Disclosure of Intended On-market Self-Purchases

[112] An advance disclosure requirement for on-market acquisitions fulfills the important functions of:

* lessening the possibility of market price manipulation, by identifying the company as the purchaser;
* limiting the opportunities for insider trading;
* countering the problem of internal inequities, and
* allowing shareholders and potential investors to make more fully informed investment decisions.

[113] In adopting the principle of market disclosure, a number of consequent issues arise:

* the matters to be disclosed;
* the timing of disclosure;
* to whom should disclosure be made, and
* the consequences of disclosure.

Matters to be disclosed

[114] The Committee takes the view that the following information should be disclosed by the company to its Home Exchange in advance of on-market self-purchases:

* the identity of the company as the intended purchaser;

* the identity of the intended broker or brokers;

* the stipulated terms and conditions of self-purchases authorised by general meeting;

* the source and amount of funds involved cf. CASA Schedule Part C Clause 3;

* whether the purchase, if successful, would have any effect on the listing of the company's securities.

[115] The Committee believes that it should not be obligatory for companies to provide other information mooted in the Discussion Paper, e.g.:

* the reasons for the acquisition;

* the dates and prices of self-purchases within the previous (say) twelve month period;

* the anticipated effect of the purchase, if successful, on the future funding and profitability of the company.

[116] However, companies may consider it beneficial to volunteer this information, and it is possible that, in time, market pressure may require it.

The timing of disclosure

[117] Any disclosure would need to be sufficiently in advance of the buy-back to allow for market dissemination of the information, yet be sufficiently contemporary to be meaningful. To achieve this, it is necessary to impose both minimum and maximum time limits.

Timing: minimum compulsory delay period

[118] Submissions varied as to the necessary minimum time between public disclosure of an intention to buy on-market and the right to acquire. The Committee does not favour a long delay period, given the potential detriment that companies may otherwise suffer in seeking to trade competitively in their shares. Extended delays may limit the capacity of companies to acquire shares at optimal times or may generate considerable share speculation in anticipation of the foreshadowed purchase. The Committee supports the shortest delay period consistent with effective disclosure and would require only two business days' notice of intention prior to commencement of on-market acquisitions.

Timing: maximum time limits

[119] The Committee takes the view that to maintain the principle of a fully informed market, the disclosed information must closely reflect the current position of the company. To ensure this, a disclosure document should have a maximum life

of six months: cf Companies Code s110(12). This requirement would not be unduly burdensome as companies wishing to continue a buy-back programme could issue a revised disclosure document up to one day prior to the expiration of the current document.

To Whom Should Disclosure be Made

[120] The disclosure document should be lodged with the NCSC and the Home Exchange of the company at least two business days prior to the company making any on-market acquisition of its shares. Where a material change occurs in the relevant information contained in a current disclosure document, the company must forthwith provide the NCSC and the Home Exchange with a new or amended document. The disclosure document would automatically lapse six months after the lodgment date, unless earlier withdrawn or replaced by a further disclosure document.

The Consequences of Disclosure

[121] The Committee considered whether any obligation should follow from a company's disclosure of intention to purchase its shares. Purchasers are normally under no obligation to give notice of their intention to acquire securities. However any person who makes a public announcement of intention to make a takeover bid breaches CASA by not subsequently undertaking the bid (subject to a change of circumstances defence): CASA s52. The Committee considered whether companies should be under a similar commitment, given the possible market price implications of a buy-back announcement. However, officers of a company making a buy-back announcement could attract liability under the Securities Industry Code Part X if, without good reason, the company fails to enter the market: Securities Industry Code s143. This may suffice to counter the possibility of companies engaging in "bluffing buys" to enhance the market price of their shares.

Disclosure of completed transactions

[122] To maintain a fully informed market companies should be required to disclose their self-purchase acquisitions. The Committee believes that disclosure should be prompt but not impose an unrealistic or unduly onerous burden on companies. To achieve this, the Committee favours a series of post-acquisition disclosure requirements:

* where acquisitions occur on-market, the company shall notify the NCSC and the Home Stock Exchange by 9.30am on the next trading day of the number of shares purchased, the prices paid and the adjusted issued share capital of the company (by deeming, for this purpose only, all buy-back contracts completed and the shares cancelled): cf CASA s39;

* the company shall establish a separate register for all share and option self-purchases (whether or not on-market) with an obligation on the company, forthwith upon entry into a buy-back contract, to disclose on this register details of:

* the number of shares/options purchased
* the consideration for the purchases
* copies of all contracts pertaining to selective self-purchases.

[123] The self-purchase register shall be held by the company at its registered office and be available for inspection by shareholders in the ordinary manner: cf Companies Code s131; s143; s231; s238; s256; s257. In the event of rescission or non-performance of a buy-back contract the company shall be under an obligation to rectify the register and, with listed securities, forthwith notify the NCSC and the Home Stock Exchange.

[124] The Committee would also favour a requirement that a summary of the number of shares of each class purchased since the last Annual Report be included in a company's subsequent Annual Report.

Status of Self-Purchase Shares

[125] The Committee considered whether these shares should be classified as:

* treasury shares, or
* cancelled shares.

[126] Treasury shares would be held by the company but without voting, dividend or other rights until resold. By contrast cancelled shares would constitute authorised but unissued capital, with the company's issued capital being diminished by the nominal value of the shares acquired.

[127] The Committee believes that in the interests of uniformity and simplicity the status of self-purchased shares should be settled by legislation rather than left to the determination of individual companies. The Committee favours cancellation of self-purchases to avoid the accounting and resale problems involved with treasury shares. The legislation should provide that cancellation, by adjustment of the company's issued share capital, take place forthwith upon settlement. To ensure that companies cannot exercise voting or other rights over these shares in the period between acquisition and settlement/cancellation, the Committee recommends that:

* prior to cancellation, shares acquired by the company shall have their voting and other rights suspended, subject to rescission or non-performance of the purchase contract;

* upon cancellation all suspended rights attached to acquired shares shall be extinguished.

[128] The implications of share cancellation for CASA and the Companies Code Part IV Division 4 (Substantial Shareholdings) are discussed at [144]-[146].

Status of Shares Acquired Other than by Purchase

[129] So far this Report has dealt with a company's acquisition of its shares by purchase. There has been at least one case where a shareholder has gratuitously disposed of his shares to the company: Re: Castiglionets Will Trusts [1958] Ch. 549. The court in that case accepted that the shares could be held in trust for the company: see now Companies Code s129(8)(e). Under the Committees recommendations, where shares are purchased they are to be cancelled. A similar principle should apply where fully paid shares are properly received by a company as a result of a gratuitous disposition.

Accounting for Self-Purchases

[130] The Committee recommends that on the buy-back of shares, the acquisition cost to the company should be applied in the following order:

* by reducing issued capital by the nominal value of the issued shares acquired;

* where the company has previously issued any shares at a premium, by writing off any acquisition premium first against the share premium account and then against distributable profits;

* where the company has not previously issued any shares at a premium, by writing off any acquisition premium against distributable profits;

* where the acquisition cost is less than the nominal value of the shares, the discount shall be credited to the profit and loss account.

Executory and Partially Performed Contracts

[131] Companies may wish to enter into conditional, instalment-based or optional share buy-back contracts (e.g. pursuant to shareholder liquidity arrangements: Discussion Paper [307]-[310]). It is possible that at the maturity date of the contract, or during the course of an instalment agreement, the company may be unable to honour its purchase commitments, thereby putting in doubt the rights of the contracting and other affected parties e.g. creditors; remaining shareholders.

[132] The Committee would prefer legislative prescription of the status and enforceability of those contracts, rather than requiring parties to rely on common law rights and remedies. The Committee examined the Canadian and UK legislation regulating these contracts and would support provisions based on these precedents: see Discussion Paper [5081]-[5083].

[133] The Committee proposes that executory contracts be specifically enforceable, except where the company proves that this would breach the solvency requirements, in which case a court may not grant an order for specific performance or damages. Until the contract is fully performed the rights of vendor shareholders shall be preserved and may be enforced whenever the company can lawfully honour the contract. Where at the commencement of a winding-up an executory contract remains outstanding, it may be enforced against the company, subject to priority for all creditors, and the liquidator's right to call up the outstanding portion of any partly-paid shares. It shall be treated as a sum due to the vendor in his capacity as a member: cf. Companies Code s360(1) (k). An executory contract with a maturity date later than the commencement of winding-up shall not be enforceable.

Self-Purchase Related Debt

[134] In acquiring its shares, a company may, as an alternative to paying cash or other consideration, prefer to incur a debt to the former shareholder. The status of any outstanding indebtedness may come into question if the company later goes into liquidation.

[135] The Committee believes that this matter would be adequately covered by adopting the principle of the Companies Code s360(1)(k) and treat the debt as a sum due to the vendor in his capacity as a member, thereby ranking such debts after the claims of creditors.

Self-Purchases as a Take-Over Defence

[136] It is anticipated that companies may employ their buy-back power as a defensive mechanism in the face of a threatened, pending or actual takeover bid or as a preventive measure to reduce their vulnerability to unwelcome offers: Discussion Paper [329][13]. Overseas jurisdictions have responded to this practice by introducing further control mechanisms: Discussion Paper [332], or alternatively mooting proposals either to proscribe or limit self-purchases by

13. Self-purchases are of limited effectiveness as a takeover defence: see Discussion Paper [330]. This is confirmed by overseas empirical studies e.g. "Defensive Tactics to Hostile Tender Offers - An Examination of Their Legitimacy and Effectiveness" The Journal of Corporation Law Vol. 11 (1986) 651 at 697-98: "It appears that although repurchasing stock is a somewhat common tactic to pursue, its effect on the outcome of the [takeover] contest is minimal at best."

Possibly the most effective current buy-back defence in the USA is the leveraged recapitalization 'poison debt' arrangement whereby the company offers to buy a substantial number of its shares in exchange for debt securities which contain covenants limiting the company's ability to incur additional debt or sell or mortgage its assets. In these circumstances hostile highly leveraged bids are unlikely to succeed: "Poison Debt: The New Takeover Defence" The Business Lawyer Vol. 42 No 3 (1987) 747 at 757-759. The Committee has elsewhere expressed its concern about "poison pill" defences: CSLRC Report to the Ministerial Council on Partial Takeover Bids (August 1985) pars [99]-[101]. In the context of self-purchases this problem may be overcome by requirements for shareholder involvement: see further [138]; [139]. This contrasts with the US position where "poison pills" can be adopted quickly by boards of directors without shareholder approval: see generally

Herzel L and Shepro R; "The Changing Fortunes of Takeover Defences" Securities Regulation Law Journal Vol. 15 (1987) 116.

target companies during the course of a takeover bid or require "competitive neutrality" between the bidder and the target company: Discussion Paper [333][14].

[137] Under Australian law, target companies might well enjoy greater freedom and flexibility than bidders in utilizing their share acquisition capacity, given that bidders must comply with the constraints of CASA. However, in the self-purchase context, the Committee does not believe that legislation should necessarily seek to remove these "competitive advantages" for target companies or otherwise require procedural equivalence. The ultimate decision as to the future membership and control of a company should rest with its shareholders, and where they are involved in self-purchase decisions that have these control implications, this principle is preserved. Rather the Committee is concerned that target company directors might engage in defensive self-purchases without the prior full and informed consent of shareholders, i.e. by exercise of their discretionary buy-back powers (10% in any twelve month period) or pursuant to a shareholder authorisation given without reference to a takeover bid.

[138] To ensure shareholder involvement in the self-purchase takeover defence process, the Committee is attracted to the London City Code Rule 37.3(a):

"Shareholders' Approval
During the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, no ... purchase by the offeree company of its own shares may, except in pursuance of a contract entered into earlier be effected without the approval of the shareholders at a general meeting. The notice convening the meeting must include information about the offer or anticipated offer"[15].

14. The argument for 'fair competition' through competitive neutrality is put by Bradley M. and Rosenzweig M.; "Defensive Stock Repurchases" Harvard Law Review Vol. 99 No.7 (1986) 1378-1430; see also "Defensive Stock Repurchase Programmes: Tender Offers in Need of Regulation" Stanford Law Review Vol. 38 (1986) 535-594. For a critique of, and reply by, Bradley and Rosenzweig see The Yale Law Journal Vol. 96 (1986) 295-338.

15. This rule applies the City Code's General Principle 7 which states that: "At no time after a bona fide offer has been communicated to the board of an offeree company, or after the board of an offeree company has reason to believe that a bona fide offer might be imminent, may any action be taken by the board of the offeree company in relation to the affairs of the company, without the approval of the shareholders in general meeting, which could

effectively result in any bona fide offer being frustrated or in the shareholders being

[139] This rule has the added merit of encouraging target company directors to act as negotiating agents for members' wishes and to advance their interests in a manner that shareholders, acting individually, could not pursue[16]. However shareholder authorization should not relieve directors of their general fiduciary duties cf. Companies Code s129(15).

[140] To avoid procedural duplication, this provision should not apply to purchases pursuant to an authorisation where the originating Notice of meeting refers specifically to the bid: see [58].

[141] Potential bidders could protect themselves by including in their offer document a 'prescribed condition' relating to buy-backs by the target company. The Committee would also favour extending the category of 'prescribed occurrences' in CASA s6 to include target company self-purchases.

[142] The related question of what regulatory restrictions, if any, should circumscribe a company's capacity to acquire 20% or more of its shares is discussed at [147]-[152].

15. cont'd - denied an opportunity to decide on its merits." cf ASX Listing Rule 3R(3) that restricts the capacity of a listed target company to allot equity securities following written notification of an actual or proposed takeover bid.

16. For a general exposition of the theory of target company directors as bargaining agents for their shareholders see Cornell Law Review Vol. 71 (1985) 53; Vol. 72 (1986) 117. A number of recent US decisions have referred to the duty of target boards "to determine, seek, and obtain maximum value for their shareholders": Hanson Trust v SCM (1986) CCH Fed. Sec. L.R. 92,418; Revlon v MacAndrews & Forbes Holdings (1986) CCH Fed. Sec. L.R. 92, 525; Edelman v Fruehauf Corporation (1986) CCH Fed. Sec. L.R. 92,863.

Shareholder involvement would also address the problem of directors utilising the self-purchase power, in the context of competitive bids, to coerce shareholders. This problem has arisen in the USA in consequence of the right of directors to authorise buy-backs without the requirement of shareholder approval. In A C Acquisitions v Anderson, Clayton & Co. (1986); CCH Fed. Sec.L.Rep. 92,942, the target company received a takeover bid conditional, inter alia, on the target not engaging in a self-tender. The directors of the target subsequently made a self-tender offer for a proportion of the company's shares, effectively deterring the bid, and so denying shareholders any opportunity to sell their shares to the outside bidder. The Delaware Chancery Court ruled that as the target company directors

had not determined that the outside bid was unfair or inadequate, their coercive response was unwarranted and in breach of their obligation to exercise their judgment to promote the interests of shareholders. The target board had a duty "to explore fully, effectively and in good faith" the merits of the takeover bid.

CASA and Substantial Shareholding Implications

[143] A self-purchase power raises various issues and implications for CASA and the Companies Code Part IV DiVision 4 (substantial shareholdings) concerning:

* the proportional share entitlement of non-tendering shareholders; and

* the proportional share entitlement of the acquiring company.

The Proportional Share Entitlement of Non-tendering Shareholders

[144] Self-purchases will increase the proportion of issued capital held by non-(or lesser) tendering shareholders and may result in the percentage entitlement of one or more of these shareholders crossing or exceeding the 20% threshold. However it would be incongruous if a company were prohibited by CASA sll from acquiring its shares (other than pursuant to CASA s12-17) simply in consequence of its existing shareholding structure. Also CASA s14 provides an exemption from sll for members who acquire shares pursuant to a pari passu allotment. There would be even stronger grounds for a similar exclusion for non-(or lesser) participating shareholders whose entitlement increases through failure to tender their shares to the company. For these reasons the Committee favours exclusion of non-tenders from the ambit of CASA s11.

[145] The Committee recognises that CASA s11, as presently drafted, may not apply to proportional shareholding increases through non-participation[17]. However to put the matter beyond doubt the Committee recommends that a further sub-section be included in CASA s12 (acquisitions to which s11 does not apply) to cover non-tenders.

17. CASA s11(1)(2) prohibits "a person" (the company) from acquiring shares only if the entitlement of "any person" (e.g. one or more non-participating shareholders) would "immediately after the acquisition" exceed the 20% threshold. A company will "acquire" its shares upon entry into the buy-back contract: cont'd

[146] To ensure compliance with the Companies Code Part IV Division 4 (Substantial Shareholdings), the legislation should oblige listed companies, upon cancellation of acquired shares totaling (initially or since any previous notice) 5% of the company's issued share capital prior to the cancellation, "a notifiable change" (cf. Companies Code s138(1)), to forthwith notify all members of the new issued share capital. Except upon proof of actual knowledge, substantial shareholders shall be deemed not to be "aware" of these changes until notified[18].

The Proportional Share Entitlement of the Acquiring Company

[147] By regulating the pace of purchases, companies could acquire their shares free of the current CASA constraints. The CASA s11 restriction applies only to increases in a person's "voting share" entitlement, which by definition (Companies Code s5(1)) excludes unissued and therefore cancelled shares. A company would breach s11 only if when it bought its shares, its total outstanding acquisitions (i.e. voting shares purchased but not yet cancelled) exceeded 20% of the company's current voting share capital.

17. cont'd
CASA s7(1); s8(7). The acquired shares will remain in existence until later settlement, and only upon cancellation will the proportional shareholding of non-participants increase. Where there is a delay between acquisition and cancellation, it is doubtful whether the percentage shareholding entitlement of non-participants could be said to increase "immediately after the acquisition" by the company. The company, therefore, could not be taken to have breached CASA s11.

Non-participants would also appear to fall outside the ambit of CASA. The s11 prohibition applies only to persons acquiring shares. Non-participants would not "acquire" shares in a buy-back as they are not parties to any "transaction": CASA s7(1)(a); s8(7), (CASA s7(1)(b) not being applicable). Therefore they would not breach s11 even where their proportional shareholding entitlement increases beyond the 20% threshold in consequence of their failure to tender.

18. The Companies Code s137; s138; s139; s141 impose an obligation on substantial shareholders to notify the company and the Home Stock Exchange within 2 business days of their becoming "aware" of their acquired status or a 'notifiable change' thereto.

[148] Given this outcome the Committee felt it necessary to consider three policy options:

* Option A: no legislative amendment, i.e., allow companies to acquire their shares free of CASA.

* Option B: modified legislative amendment, i.e. place a limit on the number of shares that a company may acquire within a set period:

* either as a fixed percentage of its original issued share capital (determined as at the date of first self-purchase), or
* as a fixed percentage of its issued shares as at the commencement of each set period,

For example, a company may acquire up to 20% of its original or current issued share capital within any 12 month period.

* Option C: substantive takeover amendment, i.e., apply CASA to buy-backs, e.g. by extending the Companies Code s5(1) "voting share" definition, in the context of self-purchases, to cancelled shares; alternatively, deem shares acquired and cancelled in buy-backs, for the purposes of CASA s11, to be issued voting shares.

[149] The Committee assessed these options by reference to the possible preference of shareholders and CASA s59 principles.

Shareholder Choice

[150] Option B allows companies to acquire, over time, effectively all, or a significant proportion, of their issued share capital. However this Option suffers the inflexibility

of limiting the pace of buy-backs regardless of shareholder preference, as reflected in their authorisations. By contrast neither Option A nor Option C imposes an arbitrary ceiling of this nature on self-purchases, and may better coincide with the wishes of shareholders.

Shareholder and Third Party Interests

[151] Option C has the merit of applying the CASA s59 principles to self-tenders, and ensures uniformity of regulation where the company and an outside bidder seek to acquire a major proportion of the company's shares. However as indicated elsewhere (see [137]) the Committee does not regard procedural equivalence between the bidder and target company as imperative. Furthermore a formal CASA self-tender requirement may result in unnecessary duplication of information, given that companies are already subject to significant shareholder and market disclosure requirements in advance of self-purchases. Option A would avoid undue duplication, while shareholder involvement in the authorisation procedure (e.g. Terms of Authorisation: [66]; [74]) would ensure that the principles of CASA s59 are satisfied.

[152] For these reasons the Committee favours Option A.

Criminal Liability

[153] As indicated in the Discussion Paper, introduction of a self-purchase power would alter the focus of criminal sanctions from prohibition to procedural breaches. The potential criminal liability of the relevant parties requires consideration.

Company Liability

[154] Where a buy-back takes place in breach of the legislative requirements, it would be inappropriate to impose a criminal liability on the company. As pointed out in the

Eggleston Committee Fifth Interim Report (para 94), if the real object of the self-purchase regulatory procedure is to protect creditors and remaining shareholders, little would be achieved by imposing a criminal penalty on the company.

Defaulting Officers' Liability

[155] The Committee would favour adoption of the terms of the Companies Code s129(5) to self-purchases. Under this sub-section each officer of the company who is in default, is guilty of an offence. "Officers" are broadly defined under the Companies Code s5(1) to include any director (as defined in s5(1)), secretary, executive officer (as defined in s5(1)) or employee of the company. The term "officer in default" is defined in the Companies Code s582 as "any officer of the corporation (including a person who subsequently ceased to be an officer of the corporation) ... who is in any way, by act or omission, directly or indirectly, knowingly concerned in or party to the contravention or failure". These provisions, combined with the terms of the Companies Code s563; s564, would apply to procedural breaches of the self-purchase power.

[156] Improper actions of directors may involve them in criminal breaches of their fiduciary duties. For instance, directors would breach the Companies Code s229 if, in preparing their Notice to shareholders, they acted dishonestly or without a reasonable degree of care and diligence. Directors may also be criminally liable where a company acquires its shares in breach of the statutory prohibition on market price manipulation or insider trading: Securities Industry Code S143. The legislation should make clear that any subsequent shareholder ratification of self-purchases does not exempt directors from criminal liability: cf Companies Code s129(15).

Liability of Other Parties

[157] The Committee considers that the current legislation would be adequate, to cover the liability of other parties.

The Companies and Securities (Interpretation and Miscellaneous Provisions) Act s38(1) provides that:

"a person who aids, abets, counsels or procures or by act or omission is in any way directly or indirectly knowingly concerned in or party to, the commission of an offence against any relevant Act shall be deemed to have committed that offence and is punishable accordingly".

This provision would apply where, for instance, a vendor shareholder was knowingly involved in a procedural breach e.g. a greenmailer acting in collusion with company directors to deceive shareholders over the reasons for, or terms of, a selective self-purchase.

Civil Liability

[158] Civil recovery rights provide both a disincentive to persons to engage in irregular behaviour and an avenue of compensation for affected parties. The Committee favours the imposition of civil liability on directors for breaches of the solvency requirements: see [87]-[88], and for abuse of their powers: Companies Code s229; s574. The Committee would also favour a provision similar to the Companies Code s129(15) to overcome any suggestion that an authorisation procedure involving shareholders relieves directors of their fiduciary duties. However directors could, in appropriate cases, seek relief under the Companies Code $535.

[159] The Committee would also support a provision similar to the Companies Code s129(6) which empowers a court to order a convicted person to pay compensation to the company or any other person who has suffered loss or damage as a result of the contravention. This provision would apply to defaulting third parties (e.g. vendor shareholders who are party to a procedural breach) as well as company officers. Given these provisions, it would not seem necessary to extend the application of the Companies Code s451 (undue preferences) to self-purchases.

[160] The Committee has elsewhere recommended [77]-[80] that irregular self-purchases be classified as valid rather than voidable or void, and therefore would not support rights of civil action to challenge completed contracts. An affected party may however seek injunctive relief (Companies Code s574), to restrain further or executory self-purchases in breach of the procedural requirements.

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September, 1987.

APPENDIX A

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Dominguez Barry Samuel Montagu Limited, Investment Bank
The Institute of Chartered Secretaries and Administrators
The Institute of Directors in Australia
Law Council of Australia
The Law Society of Tasmania
Lloyds International Limited
Westpac Banking Corporation

Appendix B

COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

DISCUSSION PAPER NO. 5
A COMPANY'S PURCHASE OF ITS OWN SHARES

JUNE, 1986

Appendix B

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Chapter 1: Current Australian Law

ORIGIN AND RATIONALE OF THE PROHIBITION

[101] The prohibition on a company acquiring its own shares (hereinafter referred to as "the self-purchase power") was authoritatively laid down by the House of Lords in Trevor v Whitworth [1886-1890] All ER 46. The House of Lords enunciated that a company cannot purchase its own shares or reduce its capital except in accordance with the statutory procedures, or return directly or indirectly the capital subscribed, other than in the course of liquidation or pursuant to statutory authority. The Court identified three interlinked policy bases behind this prohibition:

(a) Structure of the Legislation

[102] The relevant legislation required the Memorandum to stipulate nominal capital (see Companies Code s37(1) (c)) and laid down a formal procedure for reduction of capital (see Companies Code s121; 123). These provisions were interpreted in Trevor v Whitworth as manifesting a clear legislative intention that capital be maintained, subject to a statutory reduction, and this policy would be violated if companies were empowered to purchase their own shares. Companies could not unilaterally reduce their issued or paid-up capital by such means as a declaration of dividend out of capital or unauthorised reduction of capital, but:

"The stringent precautions to prevent the reduction of the capital of a limited company without due notice and judicial sanction would be idle if the company might purchase its own shares wholesale and so effect the desired result" (at 50)

(b) Ranking of Shareholders

[103] Shareholders in a limited liability company acquire

exemption from personal liability for the debts of the company. In exchange for that immunity shareholders are ranked behind creditors on the list of persons entitled to claim on the assets of a company in liquidation. A self-purchase power would place the vendor shareholders in advance of, or at least on par with, company creditors. This problem arises where a company is unable to honour its debts as and when they fall due, and focuses on the relative rights of creditors and former shareholders in the event of a company insolvency.

(c) Creditor Protection Through Capital Maintenance

[104] The maintenance of the company's capital in the interests of creditors was advanced as a principal rationale behind the self-purchase prohibition. This rested on the theory that creditors provide funds on the basis of an express or implied representation that the capital shall be applied only for the purposes of the business and that it not be returned to shareholders. Creditors have a right to look to the capital subscribed as one source for the discharge of the company's liabilities to them.

[105] It is by no means self-evident that the principle of capital maintenance is of much utility to creditors. A number of shortcomings have been referred to, namely:

* Lack of any statutory requirement for a minimum paid-up capital. The company's capital may be inadequate from the outset. Also there is no requirement for any part of the share capital to be kept in reserve for the benefit of creditors.

* The capacity of companies to issue shares for non-cash consideration where the valuations assigned to these considerations are not normally independently verified.

* Lack of any provision to protect capital, once raised, from dissipation "in the ordinary course of business". This means that the company's capital may diminish through its trading operations, changes in economic conditions, or pursuant to dividend distributions out of capital "profits" despite a decline in the company's business and the increased risk exposure of creditors.

[106] Creditors may be better protected through such mechanisms as borrowing limits in the company's trust deed; provision of adequate security; or independent assessment of the company's credit-worthiness.

[107] Despite the shortcomings in the traditional basis for the prohibition on company self-purchases, it is by no means self-evident that the granting of this power is in the interests of the company, its shareholders, creditors or the public. It does not suffice merely to point to inadequacies in the capital maintenance principle as a protective device to justify granting a self-purchase power. It is also necessary to establish that such a power may fulfil useful functions and these are not outweighed by potential problems and manipulative practices that may result.

THE STATUTORY PROHIBITION

[108] The Companies Code prohibits a company acquiring or lending money for the purchase of its shares or those of its holding company. Three categories of transaction are involved:

* a company acquiring its own shares or units of shares: s129(1) (b) (i);

* a purported acquisition by a subsidiary of shares or units of shares in its holding company: s129 (1) (b) (ii); s36(2); and

* a company lending money on the security of its shares or units of shares in itself or its holding company: s129(1) (c).

Section 129(1)(b)(i)

[109] This sub-section is drafted in very wide terms. It applies whenever a company "acquires" its own shares "whether directly or indirectly in any way". The term "acquires" is expressly defined in s129(16) to cover "any acquisition or proposed acquisition whether by way of purchase, subscription or otherwise". Moreover s129(1)(b) catches not only the acquisition of "shares" as such but also the acquisition of "units" of shares, defined under s5(1) as "any right or interest, whether legal or equitable in the share ... by whatever term called and includes any such right or interest in the share".

[110] The reference to direct or indirect acquisition is designed to overcome the otherwise obvious loophole of a corporation acquiring its shares through a nominee or agent. However there are limits on the concept of an indirect acquisition as seen in the decision of August Investments Pty. Limited v Poseidon and Samin Limited: see [131]-[142].

Section 129(1)(b)(ii)

[111] Although a holding company and its subsidiary are separate legal entities, the commercial independence of the subsidiary˜ is often minimal. In many cases therefore, the purchase by a subsidiary of shares of its holding company would have much the same effect as the purchase by the holding company of its own shares. Accordingly the sub-section prohibits the subsidiary from "purporting" to acquire shares or units of shares in its holding company. (The term "purport" is used in view of s36 of the Companies Code which prohibits the subsidiary from being a member of its holding company.)

Section 129(1)(c)

[112] A company is prohibited from lending money on the security of its shares or those of its holding company. This is designed to prevent circumvention of the self-purchase prohibition by an arrangement whereby a company lends money on the security of its shares, a legitimate or engineered default in repayment occurs, and the company exercises its right to enforce the security, thereby effectively acquiring its own shares.

[113] The "validation" procedure set out in s129(10)-(15) of the Companies Code has no application to transactions falling within s129(1) (b) or (c). This procedure applies only to the provision of financial assistance by a company to enable another party to acquire shares in the company or its holding company.

Effect of Breach

[114] Entry into a transaction in breach of s129(1)(b) or (c), which does not fall within any of the recognised exceptions or shelters, (see [119]-[143]) has criminal and civil consequences for the parties involved, and as well affects the validity and enforceability of the transaction.

Criminal Consequences

[115] Defaulting officers are liable for criminal penalties of up to two years imprisonment and/or $10,000: s129(5); s572, as are any other persons knowingly concerned in or party to the commission of the offence: Companies and Securities (Interpretation and Miscellaneous Provisions) Act s38(1) Proceedings for an offence under s129 may be instituted within the period of five years after the act alleged to constitute the breach, or with the consent of the Ministerial Council, at any later time: Companies and Securities (Interpretation and Miscellaneous Provisions) Act s34.

[116] A company itself is immune from criminal liability, on the basis that any penalty would act to the detriment of innocent shareholders and creditors.

Civil Consequences

[117] Where a person is convicted of an offence under s129, the Criminal Court may, in addition to imposing a criminal penalty, order the convicted person to pay compensation to the company or any other person of such amount as the Court specifies: s129(6). The Court may make such an order where it is satisfied that the company or some other person has suffered loss or damage as a result of the contravention.

The Validity and Enforceability of Affected Transactions

[118] Section 130(1) provides that the validity of a contract or transaction is not affected by a contravention of s129(1) (b) or (c) unless the contract or transaction effects the acquisition or loan that constitutes the contravention. This means, for instance, that a contract of purchase by a company of its own shares is void but collateral contracts are preserved. Such collateral contracts are voidable at the option of the company: s130(2). Where a contract or transaction is void ab initio or avoided, application for relief may be made to the court by any person who has, or is likely to suffer, loss or damage as a consequence: s130(4) (5).

EXCEPTIONS TO THE SELF-PURCHASE PROHIBITION

Section 129 1: Acquisitions expressly provided by the Companies Code

[119] Section 129 exempts from its prohibition corporate self-purchases allowed for elsewhere in the Code. The principal statutory exceptions are s120: redemption of

redeemable preference shares: see [126] - [128]; s123: reduction of capital: see [129] - [130]; s123(12): self-purchases by unlimited liability companies: and s320: oppression orders: .

Section 129(8~(e): Acquisition of Fully Paid Shares for No Consideration

[120] This section merely formalises the common law position which allowed such transactions, on the reasoning that there has been no reduction in the company's capital. To preserve this policy base, the sub-section requires that no consideration be provided by the company or by any corporation that is related to the company.

Section 129(8)(b): Reduction of Capital

[121] The prohibition does not apply to a payment made by a corporation pursuant to a reduction of capital under s123.

Section 129(8)(f): Purchase Pursuant to a Court Order

[122] One instance where such an order may be made is where the court is satisfied that a company's affairs are being conducted in an oppressive manner: s320. The court may order a self-purchase to allow for the retirement of one or more members.

Section 129(8)(g): Creation or Acquisition of a Lien

[123] This allows a company to take a lien on partly paid shares for any amount payable to the company. To safeguard against abuse of this exception, the lien must have been created or acquired both in good faith and in the ordinary course of commercial dealing.

Section 129(9)(a): Moneylending Transactions

[124] The prohibition on a company lending money on the security of its shares does not apply to securities given by a money-lending company in the ordinary course of its lending operations.

Section 129(9)(b) Employee Share Benefit Schemes

[125] A Company may provide financial assistance for the acquisition of its fully paid shares to be held by or on behalf of employees. These shares may be held by the company in a trust capacity or a separate trust fund may be established.

Redemption of Redeemable Preference Shares: s120

[126] A company may, if so authorised by its Articles, issue preference shares which are, or at the option of the company are, liable to be redeemed. To protect the interests of creditors such shares shall not be redeemed except:

* on such terms and in such manner as are provided by the Articles;

* out of profits that would otherwise be available for dividends or out of the proceeds of a fresh issue of shares made for the purposes of the redemption; and

* where they are fully paid up.

[127] If the redemption is paid out of profits, the capital so redeemed must be replaced by a reserve fund called a "capital redemption reserve" to which must be transferred a sum equal to the nominal amount of the shares redeemed.

[128] The Companies Legislation contains no definition of preference shares but the term would appear to cover any shares which afford the holder a preference as regards dividend, capital or otherwise. This gives companies a degree of flexibility in deciding what shares might be issued as redeemable preference shares.

Reduction of Capital: s123

[129] A company may, by complying with the procedures set out in s123, reduce its share capital by, inter alia, acquiring and canceling its shares. The statutory procedures, involving the passing of a special resolution,

settling a list of creditors entitled to object to the reduction, and court confirmation, are designed to protect the interests of creditors, shareholders and the public.

[130] There are a number of disincentives in employing s123 to effect a corporate self-purchase. The relatively complicated legal process can be both costly and time-consuming. For instance a 1979 study (Coombes R; Tress R: Return of Capital: A Legal or a Market Process? Australian Journal of Management Vol. 4 No 2 1979, p89) indicated that of 27 capital reductions examined, the average time span from announcement to final share purchase was 168 days. The time period of any particular reduction will be greatly affected by whether any objection to the reduction is raised in court. A further problem is that there is a prima facie presumption against the validity of a reduction of
capital otherwise than in accordance with the priorities on winding-up. This principle is designed to ensure equitable and uniform treatment of shareholders, but it does introduce a degree of inflexibility compared, say, with a pari passu or on-market self-purchase offer by a company. In the latter case shareholders would have the choice between a cash receipt by selling, or an increased share of ownership by retaining their shares.

Acquisition of Shares in a Company which itself holds shares in the acquiring company.

[131] A company is entitled to acquire an interest in another company which holds its shares. This principle emerges from the decision of the Full Court of the South Australian Supreme Court in August Investments Pty. Ltd. v Poseidon and Samin Limited [1971] 2 SASR 71. In that case Poseidon Limited sought to make a takeover bid for Samin Limited, the latter company holding some 200,000 Poseidon shares. It was argued that Poseidon was in effect proposing to purchase its own shares, in breach of the forerunner to s129.

[132] The Full Court ruled unanimously that the prohibition on self-purchase did not extend to a company acquiring an interest in one of its corporate shareholders. Poseidon was not purchasing either a direct or indirect beneficial interest in itself, nor becoming in law a member of itself. Samin did not hold the Poseidon shares on trust for Poseidon, nor had it agreed to do so in future. The transaction was not a direct or indirect acquisition in breach of the old equivalent of s129.

[133] The majority of the Court dismissed motive as irrelevant and ruled that nothing turned on establishing that the acquired company subsequently became a subsidiary of the acquiring company. Mitchell J dissented on this point and was prepared to hold that the prohibition on self-purchase may be violated if the acquired company had been set up for the purpose of acquiring shares in the (eventual) holding company. Likewise:

"If the sole asset of the intended subsidiary company were a parcel of shares in the proposed holding company it seems to me that the court might be entitled, in looking at the realities of the situation, to say that the proposal by the latter company was to purchase its own shares, notwithstanding the fact that nominally it was acquiring shares in the former company".

Implications of August Investments v Poseidon

[134] A company may, in effect, control a proportion of its own shares by acquiring an interest in one or more of its corporate shareholders. However there are a number of constraints on this self-purchase method. A holding company is not entitled to use a subsidiary company to acquire shares in the holding company, as this is in breach of the Companies Code s36. Where the acquired shareholder subsequently becomes a subsidiary of the acquiring company the relevant shares must be treated as non-voting shares, and be disposed

of within 12 months: s36(5). However these disabilities do not arise where the interlocking corporate arrangement falls short of a holding company-subsidiary relationship. In such instances the shares may be held indefinitely.

[135] The principles underlying August Investments v Poseidon allow for the establishment of "mutual support" networks and protective cross-shareholding webs between companies enabling shares to be held in support of existing management. A board of directors under pressure from speculation of an unwelcome takeover bid might employ this mechanism in an attempt to frustrate a prospective offer by soaking up loose shareholdings.

Policy Responses

[136] Given these glosses on the s129 prohibition, a number of possible policy responses may be considered:

*** Maintain the current law**

[137] Under this approach a company can, in effect, control a proportion of its shares through the use of mutual support networks and associates, subject to the constraints of CASA s11; Companies Code s36 (in the event of a holding company-subsidiary relationship arising) and s129 (restrictions on a company funding the purchase of its Own shares). The motives for entering into such relationships would appear not to impinge on their legality, though the actions of directors may be challenged as in breach of their fiduciary duties at common law or pursuant to the Companies Code s229 (e.g. directors seeking to entrench their position rather than acting in the best interests of the company).

*** Prohibit the Poseidon Mechanism**

[138] This approach would attempt to close the "loophole" by prohibiting a company acquiring shares or other

interests in any of its shareholders. A blanket prohibition of this nature would constitute an unjustifiable restriction on share acquisitions and take-over activity. For example, the holding by a take-over target of even a few shares in the bidder would suffice to thwart the bid.

[139] A compromise approach may be to place a ceiling on the proportion of a company's shares that may be purchased in this manner. A limitation already applies under s11 of CASA which prohibits an acquisition that could increase a person's entitlement to voting shares beyond 20%.

*** Review Motive**

[140] A further approach may be to regulate this form of self-purchase by focusing on issues of motive, and adopt, if not extend, the principles alluded to by Mitchell J in August Investments v Poseidon. Under this approach a distinction could be drawn between instances where the sole or primary motive for the transaction was to enable the company to exercise some control over its shares, and where this was merely an incidental by-product of a broader transaction. The prohibition in s129 would apply to the former case.

[141] This would be a more flexible policy approach than outright prohibition and would be designed to inhibit use of the Poseidon precedent for purposes of obtaining a degree of corporate self-ownership. The shortcoming of this option is the difficult evidential issues that it raises, particularly in determining matters of motive, and the reliance on litigation to effect its enforcement.

Reform the General Prohibition by Relaxing the Barriers to Corporate Self-Ownership

[142] This would involve abandoning the general s129 prohibition on company self-purchases. Adoption of this policy would allow companies to acquire their shares directly, without resort to the process of acquiring an interest in their shareholders. However this may not eliminate use of the Poseidon mechanism to protect against unwelcome takeover bids, considering the limitation of the self-purchase power as a takeover defence: see [330].

Other Exceptions to the Self-Purchase Prohibition

[143] These other exceptions are:

* Forfeiture of shares for non-payment of calls, or surrender of shares in circumstances which would entitle the company to enforce forfeiture. The forfeiture or surrender only affects any amount so far unpaid and no return of capital is involved.

* Surrender of shares in exchange for new shares of the same nominal value.

* Purchase by unlimited liability companies of their own shares: s123(12).

AUSTRALIAN COMMITTEES OF INQUIRY

[144] The question of whether companies should be entitled to purchase their own shares has been examined on three occasions in Australia.

Eggleston Committee: Fifth Interim Report (1970)

[145] This report pointed out that while a company cannot hold formal title to its own shares it may be possible for shares to be vested in a trustee to hold them on the company's behalf, at least where the company provided no consideration. The Committee supported a proposal that would maintain such trust arrangements but shares should carry no voting rights while they are so held.

[146] The Committee gave no consideration to the broader policy questions involving corporate self-purchase.

Interstate Corporate Affairs Commission (1977)

[147] This Discussion Paper outlined proposed amendments which would allow a company to acquire its own shares. The following reasons favouring the power were referred to by the Commission:

"The view has been advanced that financial advisers in the United States consider that a judicious purchase by a company of its own shares within reason is a desirable practice because it allows greater financial flexibility. Additionally it is said to enhance the value of the reduced number of shares in terms of increased earning power and market value related to earning power (and hence the value on reassignment) than would be possible by the investment of a company's funds elsewhere.

"It is also suggested that shares purchased by a company may be used by it in a subsequent takeover acquisition where new shares would otherwise be issued so that the shares previously repurchased by the company reduce the diluting effect on the other shareholders' equities."

[148] It was proposed that the approval procedures subsequently adopted in s129(10)-(15) of the Companies Code apply to self-purchases as well as financial assistance transactions. In addition it was proposed to provide that shares held by or for the company would carry no voting rights. It would be left to the company to decide whether the shares were to be held for resale (treasury shares) or cancelled. Disclosure requirements would apply.

[149] These proposals were not adopted, due in large measure to criticisms raised by Professor Harding of the University of NSW.

Campbell Committee (1981)

[150] The Committee considered various submissions for reform of the existing law to permit companies to purchase their own shares. It had been suggested to the Committee that the relaxation of restrictions on self-purchase might:

* permit and facilitate corporate restructuring to meet changing circumstances; e.g. it would allow the early retirement of capital no longer necessary for the operation of a company after the sale of an operating division or subsidiary;

* make it easier for unlisted companies to attract outside shareholders - without the need for public listing - as shareholders wishing to sell their holding could, under certain circumstances, be bought out by the company if other shareholders were unable or unwilling to purchase the available shares; and

* facilitate the development of stock option and like arrangements by enabling a company to purchase an employee's shares upon retirement.

[151] The Committee noted that the rationale for the prohibition was to protect both creditors and shareholders by preventing a company from:

* supporting the market in its shares, e.g. to prevent a takeover;

* assisting an outsider to take over the company; or

* reducing shareholders' funds at the possible expense of creditors.

[152] The Committee did not examine the self-purchase issue in detail, but recommended its further consideration, provided there were appropriate safeguards for shareholders and creditors.

Chapter 2: Overseas Approaches

Introduction

[201] The general trend in overseas common law jurisdictions has been to permit corporate self-purchases. The USA has moved away from the Trevor v Whitworth prohibition, and corporate self-purchase has been seen as an acceptable financial procedure. Proposals to relax the self-purchase prohibition have been put forward and adopted in Canada and the UK (though rejected in New Zealand and South Africa). However there are significant differences in the various jurisdictions as to the rules and procedures governing self-purchases.

CANADA

Lawrence Committee: Ontario (1967)

[202] The Lawrence Committee favoured granting companies the power to acquire their own shares. The Committee put forward two main lines of argument in support of this recommendation:

* the principle of capital maintenance, upon which the prohibition was originally formulated in Trevor v Whitworth (1887), was a poor safeguard for creditors;

* there were legitimate and useful reasons why a company should be entitled to purchase its own shares:

"For example, companies may wish to purchase outstanding common shares in order to provide for incentive, bonus or stock option plans without being required to extend their equity base to provide the required shares. Purchase of outstanding common shares is a feasible method whereby a company could contract its equity base as the financial requirements of the company may dictate. The right to purchase common shares could also facilitate mergers and acquisitions in some cases and certainly provides a much needed flexibility for closely held

companies and their shareholders in the event of the death or retirement from the business of one or more of the principal shareholders".

[203] The Committee also indicated that self-purchases could be used to eliminate share fractions or to collect or compromise debts owed to the company.

[204] The Committee recommended enactment of provisions comparable to the then New York Business Corporation Law which granted companies, subject to any restrictions contained in their charters (memorandum and articles) the power to purchase their own shares out of "surplus" (meaning realised profits less any accumulated past losses, which were otherwise available as dividends) unless the corporation was insolvent or would thereby be made insolvent. The Committee further recommended that companies be permitted to purchase their shares out of capital (subject to the solvency test) if the purchase was made for certain specific purposes such as eliminating fractions of common shares or collecting or compromising indebtedness to the company. It also recommended that reacquired shares might either be retained as issued but unallotted "treasury shares" or be cancelled at the option of the directors, except that cancellation would be obligatory where shares were acquired out of capital. The power of a company to purchase its shares would be exercised by directors, subject to any obligation on their part to act in good faith and in the best interests of the company. The Committee placed no limits on the number of shares that might be purchased.

Dickerson Report (1971)

[205] This report set out the principles for a new Federal Business Corporation Law. The report recommended that companies be give a self-purchase power, though it would be necessary to prevent abuses such as market manipulation, unfair discrimination amongst shareholders or insider trading.

[206] Purchases would be allowed out of funds available for payment of dividends, subject to a solvency test. The acquired shares would be cancelled and either the authorized share capital would be reduced or the shares would become authorised but unissued capital. The Committee did not support the treasury share concept.

[207] Provisions enabling companies to purchase their shares have been adopted in the federal sphere and the provinces of Ontario, British Columbia, Manitoba, Alberta, Nova Scotia, New Brunswick and Saskatchewan. The Federal Act (Canada Business Corporations Act 1975 (CBCA)) and the Ontario Act (Ontario Business Corporations Act 1982 (OBCA)) are representative of the Canadian legislation. Under these provisions:

* the self-purchase power is subject to the articles of association of the company;
* each company may determine who shall exercise the power;
* self-purchases may be undertaken by on-market acquisitions, pari passu offers to all shareholders, or selective purchases;
* solvency but not source of funds requirements apply; and
* acquired shares must be cancelled and either the authorized share capital reduced or the shares restored to the status of authorised but unissued capital. Acquired shares cannot be held as issued but unallotted treasury shares.

UNITED KINGDOM

Jenkins Committee (1962)

[208] The Committee gave brief consideration to whether a company should be permitted to purchase its shares. The Committee conceded that such a power may be useful and gave the example of where members of a small company wished to retire, the shares were not readily marketable, and the remaining members were unable or unwilling to buy the shares

at a fair price. The Committee adopted the view that a general self-purchase power would require stringent safeguards to protect both creditors and shareholders. However the Committee indicated that it was not aware of any strong pressure for introduction of the reform. Accordingly there was no justification at that time for abrogation of the rule prohibiting a company purchasing its shares.

Consultative Document: The Purchase by a Company of its Own Shares (1980)

[209] This Document, prepared by Professor Gower, provided a general historical background to the prohibition on self-purchases, outlined the case for granting companies the power to acquire their own shares, and examined a number of possible alternatives.

[210] The Document listed the main claimed advantages for corporate buy-backs:

(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 purchased 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 resell to the company;

(f) it enables companies to purchase their shares for use later in stock option plans or acquisition programmes;

(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;

(h) it permits the evolution of an open-ended investment company or mutual fund instead of having to operate through the mechanism 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.

[211] Of these claimed advantages, Professor Gower commented that (b), (c) and (d) could be valuable in the case of closely-held companies. In the case of public companies (a) - (d) were either of no or of lesser moment, (e) seemed undesirable in the case of listed securities, and (j) and (k) were actually or potentially objectionable. The only seemingly unobjectionable advantages appeared to be (f), (g), (h) and (i), though it was doubtful how much use would be made of any of them, other than (g).

Five possible reform options were considered:

Possibility A: expressly permit private companies to issue redeemable equity shares

[212] Professor Gower noted that since there was no statutory definition of "preference shares", the term would appear to cover any shares which afforded the holder a preference either as regards dividends, capital or otherwise. Accordingly, the legislation already permitted the issue of redeemable equity shares so long as they conferred some preferential rights in respect of dividends or capital repayment. Omission of the term "preference" in the relevant section (cf: Companies Code s120) would clarify the situation.

[213] If such a course were adopted it would be necessary to provide that the power to issue redeemable shares should not be exercised unless the company had another class of

irredeemable shares. This would be designed to ensure that a company, as a result of redemptions, did not end up without any members.

Possibility B: permit private companies to buy shares issued under an employees' share scheme

[214] This would be an alternative to the current method of vesting the shares in trustees.

Possibility C: additionally permit private companies the right of self-purchase

[215] The discussion paper identified a number of procedural issues that would arise from the granting of such a power. These included permissible sources of funds for self-purchases; determination of a fair price; whether purchased shares should be cancelled, or treated as treasury shares available for resale; whether to allow for executory or option contracts; and the inclusion of safeguards in the form of disclosure provisions, approval procedures, solvency requirements and insider trading liability.

[216] The paper also considered permitting a simplified form of capital reduction (cf: Companies Code s123) by dispensing with the requirement of court approval.

Possibility D: expressly permit public companies to issue redeemable equity shares

[217] The same considerations applied as in A.

Possibility E: permit public companies to purchase and cancel their shares

[218] The Consultative Document noted that any procedure would have to be tailored to the type of self-purchase. For example, it would be impractical in the case of on-market purchases to require each individual acquisition to be ratified by the general meeting. The paper favoured a more general authorisation procedure. Purchased shares should be cancelled rather than held as treasury shares available for resale.

UK Statutory Amendments

[219] The 1985 UK Companies Act Chapter VII, which reproduces the provisions first introduced in 1981 in response to the Consultative Document, grants companies the power to purchase their own shares.

[220] The Act permits a company limited by shares or guarantee and having a share capital, to issue equity shares redeemable at the option of the company or the shareholders. This represents an extension of the equivalent of s120 of the Companies Code which allows companies to issue redeemable preference shares.

[221] The UK Act permits companies with a share capital to purchase their own shares subject to satisfaction of the following conditions:

* The company's articles must permit the purchase.
* The purchase must be authorised by the shareholders: see further [223]-[226].
* The purchase must be out of distributable profits, proceeds of a fresh issue of shares, or in some cases capital: see further [222].
* The acquired shares must be fully paid.
* After purchase, the company must have at least two members, one of whom holds non-redeemable shares.
* Payment of the purchase price must be made on completion.
* An amount equivalent to the nominal value of the company's shares purchased must be transferred to a capital redemption reserve, so as to maintain capital.
* Shares acquired by the company must be cancelled, and the issued but not the authorized share capital reduced. The Act does not make provision for treasury shares.
* The company must lodge a return within 28 days disclosing details of its purchases.

Sources of Funds.

[222] The UK legislation places restrictions on the sources of funds available to the company purchasing its shares. These sources are:

* distributable profits (i.e., accumulated realized profits so far as not previously utilised by distribution or capitalisation, less accumulated realised losses so far as not previously written off in a reduction or reorganisation of capital duly made)

* the proceeds of a fresh issue of shares made for the purpose of the self-purchase, or

* in the case of private companies only, out of capital. A private company that wishes to make a purchase or redemption of its own shares must in the first instance use up any available profits before drawing on capital.

Authorisation Process.

[223] A mandatory procedure similar to that found in s129(10)-(12) of the Companies Code applies where the redemption or purchase is out of capital. An auditor's report and a statutory declaration of solvency by the directors must confirm the viability of the payment. These documents must be made available to shareholders who must approve the transaction by special resolution. Vendor shareholders are ineligible to vote on the special resolution. Public notice of any approval must be made and dissenting members and creditors may apply to the court for cancellation of the resolution.

[224] Where purchases are made otherwise than out of capital, the terms of the proposed purchase must be authorised by a special resolution for off-market purchases or an ordinary resolution for on-market purchases. Votes attached to vendor shares are rendered ineligible.

[225] The authority conferred by an ordinary resolution for on-market acquisitions can be general or limited but it must:

* specify the maximum number of shares authorised to be acquired

* determine both the maximum and minimum price which may be paid for those shares (either by specifying a fixed sum or by providing a formula for ascertaining the price, but without reference to any person's discretion or opinion)

* specify a date on which the authority is to expire, though this may not be more than eighteen months after the date on which the resolution is passed.

[226] The authority to purchase on-market may be varied, revoked or renewed by ordinary resolution.

Recovery Upon Insolvency

[227] Where a company which has purchased its shares out of capital, becomes insolvent within twelve months of making the payment, the recipients of these payments are each liable to repay an amount not exceeding the amount paid to each by the company out of capital. Furthermore every director of the company who signs the relevant statutory declaration of solvency is jointly and severally liable with each vendor shareholder, except a director who can establish that he had reasonable grounds for forming the opinion set out in the declaration.

[228] The relevant provisions of the 1985 UK Act are found in Appendix 1.

Stock Exchange Rules.

[229] In addition to these statutory requirements, the London Stock Exchange imposes further rules on listed

companies wishing to make on-market self-purchases. These include:

* A company may not purchase its shares in the two months immediately preceding the announcement of its annual or half-yearly results.

* Purchases within a period of twelve months of 15% or more of a company's share capital must be made either by way of a tender or a partial offer to all shareholders. The tender offer must be made on the Stock Exchange at a stated maximum price.

* Purchases within the limit of 15% in twelve months may be made on-market in the ordinary way, provided that the price paid is not more than 5% above the average of the middle market quotation for the ten business days before the purchase is made.

* Details of purchases, including the number of shares purchased, together with the price per share (or the highest and lowest prices paid, where relevant) must be notified to the Stock Exchange by midday of the next business day.

London City Code

[230] The City Code on Take-overs and Mergers, while not having the force of law, prescribes rules for persons utilising the facilities of the UK securities market. Rule 37, introduced in 1985, contains various provisions governing self-purchases in the take-over context:

* a deeming provision as to the effect of self-purchases on the share acquisition levels of directors and their affiliates: Rule 37.1; 37.2;

* a stipulated procedure for self-purchases by an offeree company where a take-over bid is imminent or current: Rule 37.3;

* a self-purchase disclosure obligation for an offeror company: Rule 37.4.

OTHER EUROPEAN COUNTRIES

[231] Public limited companies in EEC countries are generally permitted to purchase their shares. The laws of member States (including the UK) are guided by the EEC Second Directive on Company Law (1977), which applies to public companies and provides (Articles 19-22) that:

* transactions may only be in fully paid-up shares;

* authorisation must be given, and the terms and conditions determined, by a general meeting of shareholders. The general meeting shall determine the maximum number of shares to be acquired, the duration of the period for which the authorisation is given (which may not exceed eighteen months) and the maximum and minimum consideration. Member states may allow for retrospective validation by the general meeting of a share purchase undertaken by company directors where the purchase was necessary to prevent serious and imminent harm to the company;

* details of the purchases and the reasons for them must be set out in the annual report; the number of shares a company can acquire and hold as treasury shares may not exceed 10% of its subscribed capital;

* the acquisitions must not have the effect of reducing net assets below the amount of subscribed capital plus undistributable reserves; and

* voting rights must be suspended in respect of treasury shares so long as they are held by the company.

[232] The UK and West Germany were the first member States to bring their laws on public companies into line With the Second Directive. Other member States have since followed. By way of example, Belgium introduced self-purchase provisions in 1985, though framed in very restrictive terms:

* A four-fifths majority of shareholders who vote is needed to authorise the purchase.

* This authority is valid for a maximum period of 18 months or such lesser time as stipulated in the resolution.

* Equal treatment of shareholders must be strictly respected. The company must make an identical purchase offer to all shareholders of the relevant class; on-market or selective purchases are prohibited.

* The purchased shares may be held as treasury shares and resold within 2 years, if so authorised by a majority vote of shareholders. Shares not sold within the 2 year period must be cancelled.

USA

[233] The law in the United States has changed on whether a corporation may acquire its own shares. Originally a self-purchase power was not permitted for various reasons, including that it went beyond the valid range of objects of corporations, and that it could accomplish a reduction of capital without following the prescribed procedure. However the self-purchase power has been recognized for some decades in all jurisdictions, either by express statutory provision, or through relevant case-law.

[234] The Model Business Corporation Act has been designed by the Corporate Section of the American Bar Association as a guide for legislation at the state level (though it is not necessarily followed in its entirety in all jurisdictions). It grants to corporations the power to acquire their own shares (s6), subject to satisfaction of solvency requirements:

"Subject to any restrictions in the articles of incorporation, the board of directors may authorise and the corporation may make distributions [defined to encompass self-purchases] except that no distribution may be made if, after giving effect thereto, either:

(a) the corporation would be unable to pay its debts as they become due in the usual course of its business; or

(b) the corporation's total assets would be less than the sum of its total liabilities and (unless the articles of incorporation otherwise permit) the maximum amount that then would be payable, in any liquidation, in respect of all outstanding shares having preferential rights in liquidation" (s45).

[235] The Model Act s6 originally restricted the funds available for self-purchase to unreserved and unrestricted earned revenue surplus (a concept similar to, but narrower than profits available as dividends) and where the articles so permitted, or with the affirmative vote of the holders of a majority of all shares entitled to vote, unreserved and unrestricted capital surplus. However these requirements were deleted under 1980 Amendments to the Model Act. (See The Business Lawy-e-r Vol. 34 (1979) p1867-1889; Vol. 35 (1980) p1365; Vol. 38 (1983) p1019-1029.)

[236] The Model Act allowed for acquired shares to be cancelled (and either the authorized share capital reduced or the shares restored to the status of authorized but unissued capital) or held as issued but unallotted treasury shares. However the 1980 Amendments eliminated the concept of treasury shares.

[237] There is no requirement that self-purchases be pursuant to a general invitation to shareholders, and accordingly selective purchases from one or more shareholders are permitted. However some controls have been introduced by the Stock Exchanges. For instance the New York Exchange has taken the position that selective purchases from an officer, director or substantial shareholder of a listed company should have shareholder approval and failure to obtain it may lead to the delisting of the company's securities.

[238] The Federal Securities and Exchange Commission (SEC) has been involved in regulating issuer self-purchases since the 1968 amendments to the Securities Exchange Act. Section 13(e)(1) prohibits self-purchases in contravention of the

rules adopted by the SEC. Pursuant to that power, the SEC has created a series of rules in recognition that although market purchases may be undertaken for legitimate purposes, substantial self-purchases can have a significant impact on the market price of securities and are therefore subject to abuse.

Rule 13e-1: Purchase of securities by the issuer

[239] This prohibits the target of an actual or pending tender offer from purchasing its own securities unless two disclosure requirements are met:

* Filing of a statement with the SEC setting forth the type and amount of shares to be purchased, the names of the persons or classes from whom the shares are to be purchased, and the market in which they are to be purchased; the reason for the purchase and whether the purchased shares are to be retired, held as treasury shares or disposed of; and the source and amount of funds to be used.

* The target must have provided the substance of this information to its equity security holders within the past six months.

[240] Privately negotiated as well as open-market purchases are permitted. There is no requirement that the issuer make a general or an on-market offer to all shareholders.

[241] Rule 13e-1 helps to create a degree of disclosure parity between the issuer target company undertaking the self-purchase and the bidder making the tender offer. It also alerts the shareholders to the fact that the future market price may reflect the issuer's entry into the market, thereby enabling them to make a more accurate evaluation of the merits of the tender offer.

Proposed Rule 13e-2 as substituted by Rule 10b-18.

[242] The proposed Rule 13e-2 was designed to impose certain time, price and volume limitations on issuer

self-purchases which did not amount to tender offers. The proposed rule was a response to perceived abuses arising from use of the self-purchase power to influence the market price of the securities. The proposals were designed to prevent conduct which might disturb the orderly functioning of the market, by prohibiting the issuer from unilaterally raising the market price, creating the appearance of widespread interest in the stock through the use of several brokers, or dominating the market in volume of shares purchased.

[243] In 1982 the SEC adopted Rule 10b-18 and withdrew the proposed Rule 13e-2. Rule 10b-18 provides issuers with a "safe harbour" (immunity) from possible liability for manipulation in on-market purchases if certain conditions are met:

Limits on the time and price of the purchases. An issuer or its affiliates may not buy the company's shares on any given day until there has been an independent transaction, nor may they buy during the last half hour of trading on the Exchange. The price paid must not exceed the higher of the highest current independent published bid or the last independent sale price reported in the Exchange system.

Limits on the volume of purchases. The maximum daily number of shares to be acquired by the issuer and its affiliates must not be more than 25% of the "trading volume" of that security, defined as the average daily trading volume in the security over the four calendar weeks preceding the week in which purchases are made.

Limits on the number of brokers or dealers used to make purchases. The issuer and its affiliates are limited to the use of one broker or dealer to solicit purchases during any single day.

Rule 13e-3: Going-private transactions.

[244] This rule imposes filing and disclosure requirements on self-purchase transactions which have either a reasonable likelihood of, or are intended to cause a class of securities

to be held by less than 300 persons, or which cause the class of securities to be no longer publicly listed or quoted.

Rule 13e-4: Tender offers by issuers.

[245] Under this rule a self-tender can be made only if certain information is disseminated to its shareholders concerning the purpose of the tender offer and these disclosure documents are filed with the SEC. The rule also provides that the tender offer by the issuer must remain operative for certain stipulated periods, acceptances shall be on a pro rata basis if the offer is for less than all of a class of securities, and the issuer must permit the withdrawal of tendered securities under certain circumstances. (See further Securities Regulation & Law Report Vol. 18 No 4 (1986) p125.)

Rule10b-5: Market Manipulation

[246] Corporate self-purchases are also subject to Rule 10b-5 which makes it unlawful to employ in connection with "the purchase or sale of any security ... any manipulative or deceptive device". This rule is designed to counter market rigging and manipulation practices, including insider trading by, inter alia, requiring a company to promptly disclose publicly a self-purchase programme that may materially affect the market for or price of the securities. The Stock Exchanges adopt similar disclosure policies (e.g. the New York Exchange requires a company to promptly disclose to the public a self-purchase programme that may materially affect the market for its securities).

Chapter 3: Functions of the Self-Purchase Power

Introduction

[301] This Chapter seeks to identify the various grounds that have been advanced to support a self-purchase power. Chapter 4 outlines possible problems and shortcomings with any such grant of power, and what consequent protective restrictions may be necessary. A detailed analysis of these protective procedures is found in Chapter 5.

[302] The Committee emphasises that the various arguments found in the following chapters are put forward for the limited purpose of consideration and comment; they do not represent any settled views by the Committee, nor should they be taken as necessarily exhaustive of matters arising for examination under the self-purchase issue.

RETENTION OF POWER IN SMALL COMPANIES

[303] Where a major shareholder in a small or closely held company retires or dies, some or all of the remaining members may lack the funds or credit capacity to acquire these shares, or acquire them in proportion to their pre-existing shareholding entitlement. There may be instances where the only real option is to sell the shares disproportionately to current shareholders or sell them to a third party, thereby changing the existing balance of control. A self-purchase in these circumstances would help preserve the balance between the interests of continuing shareholders. This may be preferable in particular instances to the alternative course of a company providing financial assistance for the share acquisition.

ENHANCED OPPORTUNITIES FOR EQUITY RAISING

[304] A self-purchase power may enable the proprietors of non-public companies to raise equity capital without running the risk of jeopardising or forever surrendering control of the company.

[305] The right of self-purchase may act as an incentive for companies to offer their shares to lenders, and thereby raise additional capital. Small companies may be less reluctant to accept outside equity capital since any dilution of control would be reversible.

[306] The buy-back power benefits lenders by creating a new or further market for the sale of their shares and so alleviates problems associated with the marketability of securities in unlisted companies. Investors may be more willing to take up shares in the knowledge that they may be able to liquidate their investments through a formal company buy-back arrangement.

SHAREHOLDER LIQUIDITY PLANS

[307] Introduction of the self-purchase power may encourage the development of shareholder liquidity arrangements in smaller companies. As practised in Canada and the USA, a formal agreement is reached whereby the company alone (stock redemption plan) or the company, in combination with the remaining shareholders (stock cross purchase plan) undertakes to buy out a shareholder, according to the terms of a share valuation formula, either on an installment basis or upon the happening of certain events e.g. the death or retirement of a shareholder.

[308] An installment buy-back agreement has a number of benefits both for the vendor shareholder and the company:

* Liquidity. A predictable measure of liquidity is made available to the selling shareholder.

* Collateral. Shares the subject of a compulsory buy-back arrangement may serve as a stronger or more attractive security for loans, as they provide some guaranteed measure of liquidity.

* Budgeting. A company may not have the financial resources to acquire all shares that members may wish to tender at any given time. An installment liquidity plan based on some controlling formula (e.g. limiting purchases to an amount otherwise available for dividend distribution) allows for a more orderly and equitable system of self-purchase.

* Preserving the Company. The potential liquidity from a buy-back plan may diminish the pressure from shareholders to wind up the company in order to obtain a return of their equity contribution.

[309] A self-purchase agreement, activated upon the death of a shareholder, may be funded from the proceeds of a life insurance policy. The company is entitled to take out the policy as, by virtue of the buy-back agreement, it has an insurable interest in the life of the shareholder.

[310] Particular implementation issues arising from the use of shareholder liquidity plans are discussed at [5080] - [5084].

COMPROMISE OF A SHAREHOLDER'S INDEBTEDNESS

[311] Where a shareholder is indebted to the company, it may be to the company's advantage to settle the claim in whole or part by recovering the member's shares. A company is to some extent given this power pursuant to the Companies Code s129(8) (e).

ENCOURAGEMENT OF EMPLOYEE SHARE SCHEMES

[312] A self-purchase power could facilitate such schemes by enabling a company to fulfil employee share acquisition options. If shares are acquired and held as treasury shares

for this purpose, rather than new shares being issued, the company could directly finance the option programme out of its internal resources without diluting the ownership interests of other shareholders. Similarly, cumbersome trusteeship arrangements could be avoided by conferring a direct power on the company to acquire the shares of retiring or departing employees.

MANAGERIAL EFFICIENCY

[313] It may contribute to the efficient or harmonious management of a company's business if dissident or apathetic shareholders can be bought out by the company. In some cases there may be no ready market for the shares in question and the other shareholders may not have sufficient funds to buy out the dissenting interest. A self-purchase may also bypass resort to an oppression action under s320 of the Companies Code.

[314] While from the managerial perspective a self-purchase may be attractive, a buy-out in these circumstances may not necessarily be in the best interests of the company and its remaining shareholders. It is arguable that managerial decision-making benefits from critical scrutiny and this may be discouraged if the self-purchase power is used to eliminate opposition from within the company.

SELF-INVESTMENT

[315] A self-purchase may be seen as a prudent commercial investment by the company when the current market price is less than the perceived long-term value of the shares. This may suggest an alert management acting in the best interests of shareholders by boosting the net asset value per share.

[316] From one perspective, a self-purchase is a minimum risk investment as the risk characteristics of the company are not substantially changed. Conversely, if the company buys another company's shares, the risk to the enterprise may

be increased by the possibly unfamiliar risk characteristics of the latter company.

[317] Some companies with surplus funds may perceive self-investment as preferable to acquiring substantial or controlling interests in other companies.

FINANCIAL RESTRUCTURING

[318] A company may reach a point in its development where, through lack of new investment opportunities, contraction of its market, or a decision to scale down its operations, it is desirable to reduce its equity base. A self-purchase would enable the company to adjust its equity base and its debt to equity ratio to accommodate these changing requirements.

[319] Self-purchases may also have favourable effects on the future earnings and asset backed value of remaining shares. A purchase may return value to remaining shareholders in the form of higher nominal prices for their shares and improved performance statistics (e.g. higher or sustained dividend returns, or alternatively reduced aggregate dividend outlays with greater retained earnings).

PREFERABLE METHOD OF CAPITAL REDUCTION FOR EXCESS CAPITAL COMPANIES

[320] Companies with excess equity may be more willing to return the surplus resources to shareholders through a self-purchase programme, rather than go through the procedural complexities of a capital reduction under s123 of the Companies Code which requires court approval. A self-purchase power may therefore encourage the retirement of capital no longer needed by companies.

[321] An on-market or pari passu offer purchase programme has the additional benefit of providing shareholders with the choice between an increased share of corporate ownership (by retaining their shares) or a cash return (by accepting the

purchase offer). By contrast the mandatory acquisition power given under a s123 capital reduction binds dissenting as well as assenting shareholders. Self-purchases can, from this perspective, be a more flexible and efficient financial technique for shareholders than a capital reduction.

SPECIAL DISTRIBUTIONS AS AN ALTERNATIVE TO DIVIDENDS

[322] Self-purchases at a premium may be a means of making a once only special distribution to particular vendor shareholders without raising the general dividend rate. Remaining shareholders have the benefit of a smaller equity base and may benefit in the future from increased dividends or capital gains on the value of their shares.

DIMINUTION OF ADMINISTRATIVE OVERHEADS

[323] Selective self-purchases may be used to eliminate fractional shares and odd lot holdings which may otherwise be costly for the company to administer. Currently Australian companies can eliminate odd lot holdings through a complicated process involving other companies or persons, or by issuing additional shares to bring odd lot holdings up to a convenient multiple. This process may be undesirable if the company does not wish to expand its issued capital.

OPEN-ENDED INVESTMENT COMPANIES (MUTUAL FUNDS)

[324] The self-purchase power may encourage the creation of open-ended investment companies. Similar investment vehicles currently operate through the medium of unit trusts, under the 'prescribed interest' provisions of the Companies Code (Part IV Division 6) which include "buy-back" requirements.

[325] The potential use of open-ended investment companies as an alternative to unit trusts would depend in large measure on any legislative procedures governing self-purchases. For instance it would be unworkable if each individual purchase had to be approved by a separate resolution of shareholders. It would be feasible to operate

this form of investment company only if the legislation allowed, for, say, a "standing authorisation" to be given at each annual general meeting whereby the directors were empowered to exercise the buy-back provisions: see further [5013]-[5014].

INCREASED CAPITAL MOBILITY IN THE SECURITIES MARKET

[326] A self-purchase power may act as a conduit for excess monetary capacity and a device to increase capital mobility in the securities market. Self-purchases may permit the "redistribution of risk-taking venturesome equity capital towards new and rapidly growing companies" and away from non-growth companies or companies with surplus to needs equity. On this view, self-purchases increase investment opportunities by releasing to shareholders unneeded funds for alternative investment and thereby promote the more efficient distribution and allocation of resources in the economy.

INCREASED MARKET INFORMATION

[327] An announcement of a proposed self-purchase may supply new or further information to the market about a company's operating performance and future projects, and thereby benefit all market participants. The announcement may act as a market signal that the company considers its shares undervalued.

LESSENING THE IMPACT OF "SHARE DUMPING"

[328] Where a large shareholder in a listed public company intends to sell his shares, the company may wish to ensure that these shares are not dumped on the market, with a resulting decline in the price of its shares. It may be in the interests of the company and its shareholders to purchase these shares. A self-purchase power allows companies to directly enter the market and soak up such surplus stock, thereby increasing demand for the shares and supporting or maintaining their market price. The drawbacks of this approach, including the possibility of price manipulation and market rigging, are discussed at [406]-[410].

SELF-PURCHASES AS A TAKE-OVER DEFENCE

[329] The self-purchase power could be utilised as a defence technique in the face of a threatened, pending or actual takeover bid or as a preventive means of reducing a company's vulnerability to unwelcome offers. A defensive or preventive self-purchase programme may be undertaken for any or all of the following reasons:

* To lessen the attractiveness of the take-over target by altering the company's financial profile. The self-purchase programme would be designed to reduce the company's cash reserves and/or increase its loan to equity gearing ratio (a variant of the "scorched earth" defence) as well as improve the company's long term fiscal performance (e.g. increased earnings on the remaining shares). Defensive self-purchases may be most effective in the face of a "boot strap acquisition" bid, i.e., where the bidder plans to finance the bid by eventually utilising the target cash or credit resources (e.g. Re Wellington Publishing Company Ltd. [1973] NZLR 133). This points to a possible anomaly which allows a successful bidder to use target company assets as a security to finance the acquisition, but which prevents an incumbent board from using these assets in a defence. The capacity of bidders to, in effect, finance their bid on the strength of the target company assets focuses attention on the equity of this aspect of take-overs.

* To support the market price of the company's shares and thereby thwart or diminish the capacity of potential or actual bidders to obtain a share foothold ('beachhead acquisition') at a reduced cost. Knowledge that the company is prepared to pay a higher than current market price could cause a re-evaluation by investors of the worth of the shares. With an increased market price, it is arguable that all shareholders (both vendors and non-participants) would be better off (provided the

higher price was maintained) and the danger of the take-over bid, based on asset-stripping motives, could be reduced.

* To "mop up" floating or uncommitted shares which a bidder may otherwise acquire as an easy first step in its take-over bid.

* To eliminate potentially dissident or wavering shareholders and so remove the threat of the shares falling into the hands of a "hostile" bidder.

* To "buy off" potential bidders by acquiring their shares, usually at a premium to market price (greenmail).

* To enhance the proportional holding of an existing control or management support group.

* To create a competitive price environment which may result in a greater return to shareholders, even if the self-purchase does not block the bid.

[330] However there may be significant impediments or disincentives in utilising the self-purchase power as a take-over defence:

* The number of shares that can be acquired will be limited by any restrictions imposed by the legislation on the sources of funds available for self-purchases: see [5025]-[5033]. Even without such constraints, a self-purchase programme of any magnitude may create major funding problems for the company. Self-purchases on a large scale are only possible where the target has sufficient unrestricted assets to support borrowings used to finance the acquisitions and/or where the company has the capacity to quickly sell its securities to friendly acquirers.

* A target company would normally only have the capacity to launch a partial self-bid (assuming this was allowed for in the legislation). This may be less attractive to shareholders than a full bid by an outside party.

* The self-purchase programme may succeed in sustaining or increasing the market price of the shares, but this benefit to the target may be offset by the bidder having to acquire fewer shares in order to achieve control. This is the case where companies are required either to cancel purchased shares, or hold them as non-voting treasury shares. Where the bidder is already a shareholder, the self-purchase programme would serve to increase the bidder's percentage of the shareholding of the company. To this extent self-purchases may be less effective as take-over defence mechanisms than protective cross share buying, where the shares retain their voting power: see [131]-[135].

* Where the target purchases its shares at a substantial premium, a bidder may sell (subject to CASA s35) some of its shares back to the target at a considerable profit with minimum diminution of its percentage shareholding.
(This possibility was recognised by the directors of the target company in Unocal v Pickens 608 F. Supp. 1081 (1985). The bidder had acquired 13% of Unocal shares and had made a tender offer for an additional 37% of Unocal shares at $54 per share. Unocal responded with its own partial tender offer for 49% of the shares, offering senior subordinated debentures having a face value of $72 per Unocal share. Unocal directors believed that, given the expected very high acceptance rate by shareholders, this defensive 'scorched earth' strategy would succeed only if it excluded the bidder from participation in its tender offer. Otherwise, the bidder could tender its shares, have the pro-rated portion of its shares purchased by the target company at a huge profit to the bidder, and retain its unpurchased shares, representing

approximately the same percentage of Unocal shares as before the partial self-tender. Accordingly, Unocal made its self-tender offer to all shareholders, except the bidder, thereby significantly increasing the number of shares other shareholders could sell and dooming the bidder to huge losses since the market price of Unocal shares would undoubtedly decline sharply after Unocal's tender offer. This "reverse greenmail" strategy was upheld by the Delaware Supreme Court. The SEC has since indicated its opposition to this strategy, and has foreshadowed the introduction of an "all holders" rule that would bar such discriminatory offers. This strategy would not be available in Australia as CASA applies the policy of equal opportunity: s16(2)(c); s17(2); s40; s59.)

* The self-purchase power may be unable to achieve the objectives of buying-off dissident or wavering shareholders or potential bidders if anti-greenmail provisions were in force: see [5010]; [5046]-[5048].

* The self-purchase programme may come too late to significantly influence the outcome of the bid. The procedural requirements may be too time-consuming to provide companies with a quick and effective response to an anticipated or announced bid: see [5007]-[5018].

[331] Recognising that the self-purchase power may be used as a take-over defence, overseas jurisdictions have introduced or proposed various control mechanisms.

[332] The London City Code on Take-Overs and Mergers Rule 37.3(a) provides that during the course of a take-over offer, or where the target directors have reason to believe that a bona fide offer might be imminent, the target company shall not purchase its shares (except pursuant to an existing contract) without the approval of the shareholders in general meeting: (cf: AASE Listing Rule 3R(3)). This is in addition to the authorisation procedure required under the UK Companies Act. Rule 37.3(b) requires that during the offer period, the offeree company must immediately disclose to the

Exchange, the Panel and the press the total number of its own shares which it has purchased in the market or otherwise, and the price or prices paid. The offeree company must also disclose the total number of outstanding issued shares following a self-purchase; cf. CASA s39.

[333] In the USA, the SEC has expressed concern at the use of self-purchases as a take-over defence mechanism. It believed that defensive self-tenders were too often motivated by the self-interest of directors and existing disclosure obligations (Rule 13e-1; 13e-4: see [239-241]; [245]) did not provide sufficient protection. Initially the SEC sought a ban on defensive self-tenders during the course of a take-over bid. However this policy was modified in a 1984 Congressional Bill (HR 5963) which proposed a prohibition on a self-tender during the course of a take-over offer by another bidder, except when the self-tender had been approved by the affirmative vote of a majority of the aggregate voting securities of the issuer. The promoters of the Bill argued that a self-tender may be consistent with shareholder objectives, provided shareholders were adequately informed about the terms and purpose of the self-tender and consent to it. The Bill has since lapsed.

[334] From the above discussion the following questions arise. Given an actual or pending take-over bid:

* Should offeree companies be entitled to mount a self-purchase defence?

* Should there be any restrictions on the number of shares that may be acquired? For instance should offeree companies be entitled to self-tender?

* Would it be appropriate to introduce specific procedural requirements, such as found in the London City Code or the US Congressional Bill for (a) all self-purchases, or (b) self-tenders only, by the offeree company, during the anticipated and/or actual offer period?

[335] Introduction of the self-purchase power, and its potential use as a take-over bid defence, would also appear to require some fundamental reformulation or clarification of the powers and duties of target company directors, e.g. in what circumstances would it be appropriate for them to use corporate assets to defend against a take-over bid? This raises legal questions concerning the purposes and motives of company directors which are only dealt with to a limited extent in existing Australian company law: see further [415]-[424].

LEVERAGED BUY-OUTS: PUBLIC COMPANIES GOING PRIVATE

[336] The self-purchase power has been utilised in the USA to restore "close control" of public companies through financial arrangements known as leveraged buy-outs. These usually involve the company undertaking a self-tender for the purpose of contracting its capital base and/or providing financial assistance by way of loan securities to enable the management group to acquire all or a majority of the outstanding shares. A buy-out may be prompted by a desire of management to gain greater autonomy in decision making, eliminate public accountability to shareholders, or protect management against the consequences of an unwelcome take-over bid (see generally Lowenstein L: "Management Buyouts" Columbia Law Review Vol. 85 No 4 (1985) p730-784).

[337] Use of the self-purchase power to effect a buy-out has been criticised as contrary to the principle of encouraging wide public equity participation. It has been argued that it is prima facie undesirable, from the perspective of public policy, that legislation should facilitate the reduction or elimination of public ownership of companies. Introduction of a self-purchase power (combined with the existing financial assistance provisions: s129(10)) may result in a reduction in the levels of public equity participation, and this is arguably against the public interest. Similarly

Australian Stock Exchanges, which seek to attract more equity to the securities market, may be concerned about public companies buying out their shareholders.

Chapter 4: Problems Arising From The Self-Purchase Power

Introduction

[401] The arguments against granting companies the capacity to purchase their shares have as their common premise a concern that this power may be open to substantial abuse or misuse. This concern has been longstanding. For instance in Trevor v Whitworth (1887) 12 App. Cos. 409 at 435, Lord Macnaghten observed that it may be detrimental to the management of companies to allow directors to buy out inquisitive and troublesome critics. In an earlier case, the court commented that a self-purchase power may result in companies speculating or trafficking in their own shares: Hope v International Financial Society (1876) 4 Ch D 327 at 339. More recently a number of Canadian commentators have concluded that:

"Considering the potential for abuse of the power and the necessary safeguards and checks which must be adopted, we seriously wonder whether the power to purchase is warranted ... we do not believe the case for companies needing the power has been shown to outweigh the serious disadvantages." (Iaccobucci F; Pilkington M; Prichard J: Canadian Business Corporations/ An Analysis of Recent Legislative Developments (Canada Law Book Co.) 1977 p121).

[402] In Australia strong reservations were expressed by Professor Harding of the University of New South Wales in a series of articles (Commercial Law Association Bulletin Vol. 10 (1978) pl-27; 31-38; 53-61).

[403] This Chapter outlines and analyses the various criticisms of the self-purchase power. At issue, is whether

the advantages of a self-purchase power are outweighed by the dangers that the power will be abused, and the difficulties of regulating against such abuses.

INTERNAL INEQUITIES

[404] An unregulated self-purchase power may result in improper discrimination between shareholders, e.g. where favoured members are brought out at a substantial premium to the market or true value of the shares. Another possible instance may be where a company acquires shares at a discount to their true value, thereby increasing the equity value of the remaining shares at the expense of the vendor shareholders.

[405] The potential for disparate treatment may be lessened by the application of existing statutory (Companies Code s229) and common law (e.g. Coleman v Myers [1977] 2 NZLR 225) fiduciary duty doctrines, and other shareholder remedies: s320; s364(1) (f)(fa) (fb) (j); s574. Discriminatory self bids would be prohibited under CASA. However it is questionable whether these protections are adequate without further procedural safeguards. These could:

* Require that self-purchases be approved by a special or ordinary resolution of shareholders, who have been provided with full and complete information on the affairs and prospects of the company pertaining to the purchase, as well as any other information which would enable them to assess whether the shareholders would be treated fairly and equally by the proposed purchase: cf s129(10) (12). See further [5008]-[5012];

* Ensure that there is full and complete public disclosure by the company in advance of its on-market or off-market purchases, so that each shareholder would have an equal opportunity to make an informed decision concerning the self-purchase. See further [5064]-[5069]; and/or

* Confine off-market purchases to pari passu offers to all shareholders within the class of affected shares. This would provide all shareholders with an equal opportunity to sell their shares and may overcome the otherwise perceived lack of independence and arms-length buying inherent in any situation where a company is dealing with controlling or influential shareholders. A range of exceptions may be necessary to the principle of "all holders" offers, particularly with close corporations, as otherwise the requirements may be too inflexible. A procedure analogous to CASA s12(g) might be appropriate, thereby allowing for selective purchases with the consent of the remaining shareholders: see further [5042]-[5050].

MARKET PRICE MANIPULATION

[4063 In an efficient market, the price for any security represents an equilibrium between demand and supply. A substantial increase in buying, reflecting increased demand, without any corresponding increase in supply, should lead to higher market prices. A substantial purchase by a public listed company of its own shares could significantly increase their market price. Company controllers may seek therefore to exercise the self-purchase power in order to:

* retard or reverse a decline in the share price and thereby create a new market price equilibrium by "soaking up" a proportion of the shares offered for sale;

* put a "floor" under the current market price so as to preserve for shareholders the value of their marketable securities;

* neutralize inexplicable short term fluctuations in the market price and thereby maintain a more stable share price;

* lessen or eliminate any discrepancy between the market price of the shares and their estimated long-term net

* asset backing; e.g. where a company has undertaken a major investment which has temporarily depressed the price of its shares;

* protect incumbent management from exposure to shareholder discontent that might otherwise follow from a substantial decline in the market price of the shares;

* improve the market price for the purpose of attracting new investors, thereby increasing demand for the shares and further raising the market price (snowball effect);

* influence the market price of the shares in anticipation of the company conducting a take-over bid or entering into merger negotiations, where its shares are offered as consideration in whole or part;

* support the market price (through limited self-purchases) where the company intends to make a further (and larger) issue of shares, the success of which may be jeopardised by any decline in the price of existing issued shares;

* support the price of company shares pledged by shareholders as security for loans; support the price of company shares where the company intends to offer its shares as consideration in the acquisition of assets;

* allow a company to raise necessary additional equity capital in a manner that minimises dilution of the ownership interests of existing shareholders. Selective purchases, designed to maintain or increase the market price of the shares, may allow the company to issue fewer shares, but at a considerable premium.

[407] The market price of shares may also be affected if companies are entitled to hold reacquired shares as treasury shares rather than cancelling them. An unregulated self-purchase power may enable a public company to buy shares, hold them as an asset, and later resell them. The company would then have the ability to advance the market

price through large-scale anonymous purchases, and likewise depress the market price by putting a large block of purchased shares back onto the market.

[408] Self-purchases, for the purpose of influencing the share market price, may constitute a form of market rigging, in breach of the Securities Industry Code (Part X; cf North v Marra Developments Ltd. (1981) 37 ALR 341) and other State based criminal legislation. However this legislation may not suffice to counter the potential for price manipulation. It may also be necessary to impose on companies an obligation of full and complete public disclosure of its self-purchase intentions and transactions. By this means, the market, the company shareholders and potential investors would be made aware of the influence of the company in the market, and thereby could make more reasoned investment decisions.

[409] In the USA, the SEC has responded to the problems of market price manipulation by introducing Rule 10b-18, which provides a company with a "safe harbour" (immunity) from liability for manipulation in connection with self-purchases, provided certain limitations concerning the time, price and volume of the purchases by the company and its affiliates are met: see [242]-[243]. The London Exchange has similar control mechanisms: see [229].

[410] From the above discussion, the following issues arise for consideration in the event that the self-purchase prohibition is relaxed:

* In what circumstances, if any, should companies be entitled to trade in their shares for the purpose of influencing the market price?

* What measures would best guard against improper share price manipulation? See further [5051]-[5069].

* Would there be merit in introducing a self-purchase immunity provision modelled on the SEC Rule 10b-187

INSIDER TRADING

[411] An unregulated self-purchase power could increase the possibility of insider trading both by the company which acquires its shares and other insiders.

[412] A company would breach the insider trading provisions if it acquired its shares while its decision-makers were in possession of confidential price sensitive information concerning those shares: Securities Industry Code

s128(6) (7). It would not be uncommon for a company to have material information of this nature in its possession, and this could severely inhibit its capacity to purchase its shares. Public release of such information may not suffice to avoid the company engaging in insider trading unless the market is able to appreciate its price sensitive qualities. (What constitutes sufficient publication turns on the meaning of such phrases as "information ... not generally available" in s128(1) and "... knew or ought reasonably to have known" in s128(10).) Even if no breach of s128 takes place, the impression could still be created that the company has unfairly taken advantage of the market.

[413] Insiders may also benefit improperly from corporate self-purchases. For instance, insiders who are aware that the company proposes to acquire its shares at a premium price to the market, may be tempted to acquire company shares in advance of any public announcement of the intended purchase. The possibility of such illegal gain from insider trading is not peculiar to self-purchases (e.g. knowledge by insiders of a company's intentions regarding trading in the shares of other companies is an equally fertile ground for insider trading); corporate self-purchases merely create another avenue for its exercise.

[414] The likelihood of insider trading may be lessened if companies are required to provide full disclosure both of their intentions to embark upon purchases, and of all

relevant price sensitive information. Corporate self-purchases create a category of information which is both price sensitive and material in terms of informed investment decisions, and this should be readily available to the market: see further [5064]-[5069].

IMPROPER ATTEMPTS TO SECURE OR CONSOLIDATE CORPORATE CONTROL

[415] The initiative to exercise the self-purchase power would usually lie with the directors, albeit that shareholders consent for such acquisitions may be required. This creates the potential for abuse to the extent that directors may act in their own interests and in breach of their fiduciary duties to the company. The potential conflict of duty and self-interest would arise where directors embark upon a purchase programme for the purpose of gaining or maintaining their control of the company or to defend against an actual or potential takeover bid.

[416] This fiduciary duty issue has not arisen directly in Australia although the courts have examined whether the interests of the company as a whole justify directors in engaging in other defensive activities such as share issues (Harlowe's Nominees Pty. Ltd. v Woodside (Lakes Entrance) Oil Company NL (1968) 121 CLR 483; Howard Smith Ltd. v Ampol Petroleum Ltd. [1974] AC 821), mergers, expansions or formation of new companies (Winthrop Investments Ltd. v Winns Ltd. (1979) 4 ACLR 1; Rossfield Group Operation Pty. Ltd. v Austral Group Ltd. (1980) 5 ACLR 290; Pinevale Investments Ltd. v McDonnell and East Ltd. (1983) 8 ACLR 199) or creation of employee share trusts (Condraulics Pty. Ltd. v Barry and Roberts Ltd. (1984) 8 ACLR 915).

[417] In the USA, allegations that directors of companies have breached their fiduciary duties in exercising the self-purchase power are dealt with by reference to the business judgement rule. This rule is based on the
presumption that the directors of a company have acted

properly unless a plaintiff can establish that a transaction was tainted by directors' self-interest (a violation of the fiduciary duty of loyalty) or that the directors did not give the matter the attention it merited (a violation of the fiduciary duty of care). The presumption will not be overcome if a "good faith decision" can be attributed to any rational business purpose; a court will not substitute its own notions of what is sound business judgement.

[418] The business judgement rule will not protect directors from breach of fiduciary duty where they have effected self-purchases for the sole, or overriding purpose of preserving or entrenching their management. However, subject to this limitation, the business judgement rule has been characterised as a shield for strenuous target company defence tactics, including issuer self-purchases. This has been illustrated in a number of recent cases.

[419] In Crane Co. v Horsco Corp. 511 F Supp 294 (1981) the Delaware Supreme Court ruled that the board of directors may show a valid corporate purpose in one of two ways:

"It can show either that some consideration other than the perceived threat to control was the primary reason for the stock purchase, or it can admit that the stock purchase was intended primarily as a defensive maneuver, and show that the directors reasonably determined that a change in control would constitute a clear threat to the future business or the existing, successful policy of the corporation" (at 305).

[420] These principles were applied in Turner Broadcasting Systems v CBS (1985) (CCH Fed. Sec. Law Reports 92, 440) which held that the CBS board exercised their proper business judgment in formulating a take-over defence that included a self-purchase. The board could reasonably conclude that the offer, with its use of high risk securities ("junk bonds")

and questionable financial desirability, was not in the best interests of the shareholders. The mere fact that the directors remained on the board was insufficient to taint their actions; self interest was not their sole or primary purpose.

[421] In Unocal v Pickens 608 F Supp 1081 (1985) the Delaware Supreme Court upheld the right of a company to make a discriminatory self-tender offer, ruling that the target's board of directors had broad discretion under the business judgement rule to take defensive action in the face of a hostile tender which it determined was inadequate. In Pogo Producing Co. v Northwest Industries Inc. (The Review of Securities and Commodities Regulation Vol. 19 No 2 (1986) p25) the bidder argued that the target company's defensive self-tender had no legitimate purpose and was nothing more than the directors' attempt to preserve their control. The court was not persuaded by this argument and concluded that the self-tender was made in good faith and was not primarily motivated by a desire to entrench the incumbent directors. The court held that it was reasonable for the directors to conclude that the bidder lacked the experience to manage the target, and to justify the defensive self-purchase on these grounds.

[422] These cases emphasise that under the business judgement rule, target self-purchases will be found illegitimate only if their primary purpose is the entrenchment of the present management.

[423] Some dissatisfaction has been expressed in the USA with this state of the law. A 1984 Congressional Bill (HR 5695) would have required the management of a target company to satisfy the business judgment rule, and also show that a defensive self-tender was prudent for the target and fair to its shareholders. The Bill has since lapsed.

[424] From this discussion the following issues arise:

* Are the principles derived from existing Australian law on directors' fiduciary duties suitable for application to self-purchases? Would it be possible, for instance, to differentiate between proper and improper use of the self-purchase power?

* Should Australian law move in the direction of applying the business judgement rule, with or without the gloss of the Congressional Bill, in the context of self-purchases?

* To what extent may these fiduciary duty problems be resolved by reliance on shareholder approval or ratification of the purchases? Should shareholders of the target be entitled to ratify such breaches or approve purely defensive self-purchases? Would shareholder ratification fully protect the interests of other affected parties, such as creditors?

GREENMAIL

[425] The term "greenmail" applies to privately negotiated selective self-purchases, usually from a dissident shareholder, at a premium to market price. As used in this sense it is to be distinguished from the existing Australian variation of greenmail whereby "acquisitors" are bought out,
not by the company, but by one or more of its supporters or "white knights", with the possibility of the company providing financial assistance for the purchase.

[426] Greenmail purchases are intended as a defensive technique, employed by management to rid the company of shareholders threatening to initiate a take-over bid or otherwise disrupt the company's affairs (e.g. by mounting proxy contests), unless their shares are purchased by the company at a premium. Greenmail purchases are frequently accompanied by "standstill agreements" whereby the vendor shareholder undertakes to limit its shareholding in the company for a specific time period.

[427] In the USA greenmail transactions are becoming both more frequent and controversial, and it appears that some corporate investors are amassing shares simply for the purpose of selling their holdings back to the target companies at a significant profit.

Support for Greenmail

[428] The practice of greenmail has been defended as potentially beneficial to the target company and its non-participating shareholders, and that to introduce restrictions may have deleterious consequences. Theoretical support for this position is found in two theses:

* information thesis;
* shareholder welfare thesis.

Information Thesis

[429] This thesis argues that greenmail premiums represent an efficient means of compensating persons for supplying important information to the company, its shareholders and the market, about the value of the company's shares. Potential greenmailers make a considerable contribution to the process of market value creation by locating undervalued shares and transmitting this information to the market via the greenmail transaction. The purchase premium acts as a "finder's fee" for this information-providing activity. Greenmail permits sellers of information to specialise in this activity, and provides them with a return, without having to proceed to a take-over bid or otherwise involve themselves in management. Specialisation in providing this information lowers costs, leading to an overall increase in (a) information produced to the company, its shareholders and the market; (b) take-over bids generated; and (c) the monitoring of management.

[430] The placing of constraints on greenmail transactions would, according to this thesis, lessen the incentive for greenmailers to invest significant resources in this information gathering exercise.

Shareholder Welfare Thesis

[431] According to this view, greenmail purchases eliminate troublesome minority shareholders, may protect shareholders from inadequate offers by "predators", and allow management to concentrate on profit-generating endeavours to the benefit of non-participating shareholders. The long-term cost and opportunity savings in buying out disruptive greenmailers may outweigh any losses or incremental inefficiencies resulting from the premium payment.

[432] Greenmail may also facilitate an auction market for the company's shares. Premium purchases could be interpreted by the market as an indication that the company's shares are under-valued. Removal of the greenmailer through a buy-out (linked to a "standstill agreement") provides other potential bidders with more time and information to formulate their bids. Unlike other defensive measures (e.g. mergers; share issues; shark repellant articles), the effect of greenmail is confined to the acquisitor and does not directly discourage other take-over bids (though the premium paid may lessen the attractiveness of the company as a target, in which case greenmail could be described as analogous, in effect, to "scorched earth" or "sale of the crown jewels" defences).

Objections to Greenmail

[433] Criticism of greenmail has taken three principal forms:

* management entrenchment thesis
* shareholder unfairness thesis
* manipulation thesis.

Management Entrenchment Thesis

[434] This thesis argues that directors may engage in, or sponsor, greenmail transactions for no better reason than a self-serving attempt to prevent a shift in corporate control

that could jeopardise their position. Directors may employ corporate assets to protect themselves against take-over bids that could otherwise benefit non-participating shareholders. Selective premium purchases may constitute a collusive mutual self-interest activity between company controllers and greenmailers, to the detriment of other shareholders.

[435] The loss to the company and its remaining shareholders, is not confined to assets dissipated in greenmail transactions. The ability of a company to offer premium purchases may be used to induce parties to retire, rather than undertake a take-over bid. In this way, greenmail may reduce competition for corporate control and deny to non-participating shareholders the benefits of that competition.

[436] This thesis contradicts the view advanced under the shareholder welfare thesis that greenmail may encourage take-over bids or an auction market in the company's shares.

Shareholder Unfairness Thesis

[437] Under this thesis greenmail purchases treat shareholders unfairly, with the greenmailer pre-empting for itself all or part of the premium usually available to all the shareholders upon a formal take-over bid. Greenmail violates the principle that all shareholders of a particular class should be treated equally by the company. It is also inconsistent with the view that each share provides identical rights and commands the same unit price regardless of the quantity owned by various shareholders. Greenmail thereby fosters and encourages shareholder discrimination.

[438] This thesis also disputes the claim under the information thesis that greenmail premiums represent a separate and beneficial payment for information. Critics of greenmail claim that it provides little real information to the market other than that certain persons are engaging in this coercive exercise.

Manipulation Thesis

[439] Potential greenmailers may, by careful selection of target companies, and reliance upon their own reputation as "acquisition-minded", effectively achieve a "no loss" outcome. If the target, in response to the take-over or other disruptive threats of the acquirer, agrees to a merger or take-over, the acquisitor gets a friendly acquisition with little risk of a competing bid; if the target responds by promoting its own friendly bidders, the acquisitor can always sell out to a "white knight" of the target, usually at a substantial profit; if the target is willing to discuss a share buy back, again the acquirer can gain financially. In effect, the acquirer is relying upon its ability to assemble a shareholding block at a relatively low price and then stimulate the dynamics of a take-over bid for its own ends.

According to the manipulation thesis, this constitutes an unwarranted and unjustified power in the hands of particular individuals and corporations.

Empirical Analysis

[440] A series of American studies have examined the overall impact of greenmail transactions on non-participating shareholders, as measured in terms of the company's share price performance. The results, while not uniform, favour the conclusion that share prices decline significantly in the wake of greenmail payments, and such decline outweighs any price increases arising from the initial greenmail acquisitions (see Journal of Financial Economics Vol. 11 (1983) p275-300; 301-328; The Yale Law Journal Vol. 95 No 1 (1985) p43-48; Harvard Law Review Vol. 98 (1985) p1051-1056). The majority conclusion is that greenmail is deleterious to shareholder welfare.

[441] A Study by the SEC office of the Chief Economist in 1984: The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices, found that the payment of greenmail was against

the best interests of non-participating shareholders:

"The evidence suggests that non-participating shareholders suffer substantial and statistically significant share price declines upon the announcement of targeted repurchases at premiums above market value. The overall impact on share prices from the date the initial foothold position is established to the date the block is repurchased is also negative. The appreciation in stock prices caused by the initial foothold acquisition is more than offset by the decline in stock prices in response to events subsequent to the initial acquisition, on average... We conclude that the overall impact of targeted share repurchases on the wealth of non-participating target shareholders is negative. The stock price evidence indicates that the magnitude of losses to non-participating target shareholders is at least equal to the wealth loss implied by the cash premium paid for the block repurchase. The losses are more severe in cases where there is evidence that the foothold acquisition and disposition was associated with a struggle for corporate control, such as a possible tender offer or proxy fight."

Legislative and Judicial Response in the USA

[442] There is currently little legislative inhibition on greenmail transactions at the State level, though some jurisdictions are now introducing restrictions. For instance, the State of New York in December 1985 passed legislation prohibiting a company purchasing 10% or more of its shares at a price higher than the market value, unless the premium purchase was approved by both the company's board of directors and shareholders. This anti-greenmail provision would not apply to a pari passu premium offer to all shareholders or the selective premium purchase of shares that had been owned for more than two years. The State of Indiana

introduced similar laws in 1986, for the stated purpose of preventing financiers from purchasing large blocks of shares, then forcing the target company to buy them back at an inflated price.

[443] The only relevant Federal legislation is the general anti-fraud provisions of rule 10b-5 and the tender offer anti-fraud provision of s14(e) of the Securities Exchange Act. However in order to successfully challenge a greenmail transaction under these provisions, a plaintiff must prove that the target's directors either misrepresented the company's affairs or failed to disclose material information during the greenmail transaction. These provisions do not look to the substantive fairness of management's defensive actions.

[444] The SEC proposed, in 1984, that legislation be introduced to prohibit a target company purchasing its shares, at a premium to market price, from any person who held more than 3% of the company's shares for two years or less, unless the shareholders approved the selective purchase, or the company made the same purchase offer to all shareholders. Draft Bills were introduced in Congress in 1984 (S2782) (HR5693) and 1985 (S286), but were not proceeded with.

[445] Greenmail transactions are subject to the business judgement rule, and in this context mirror the rule's traditional application to managerial actions affecting corporate control generally. Under the rule, the directors of a company paying greenmail are required to state the business purpose of corporate actions taken to thwart a take-over bid. If the court views the greenmail payments as simply a vehicle for entrenching incumbent management, and the managers cannot provide coherent alternative justifications, such payments may be prohibited. Similarly, if retention of control is a factor in the management's decision to enter a greenmail transaction, the directors must show that the transaction was fair and reasonable to the

corporation. However under the business judgement rule the initial burden remains on the plaintiff to show that the directors have breached their fiduciary duties of loyalty or care. (A useful summary of the leading cases is found in The Yale Law Journal Vole 95 No 1 (1985) p53-60; Harvard Law Review Vole 98 (1985) p1056-1059.)

[446] These case-law principles may be exemplified in two recent decisions. In Polk v Good (Securities Regulation and Law Report Vol. 18 No 12 (1986) p404) the Delaware Supreme Court upheld a greenmail transaction in the face of a complaint that the premium paid was excessive and the purchase did not serve any legitimate corporate purpose. The Court ruled that the complainant did not meet the heavy burden under the business judgement rule of establishing that the directors' action in approving the purchase was not made in good faith or independently (a violation of the fiduciary duty of loyalty):

"The payment of a premium ... seems reasonable in relation to the immediate disruptive effect and the potential long-term threat which the [greenmailer] posed. Clearly [the greenmail buyout] was a benefit to the company and most of its stockholders."

[447] Remedies arising from breach of the business judgement rule were examined in Heckman v Ahmanson 214 Cal. Rptr (1985). A California State Appeals court granted an injunction to the plaintiff shareholders who had objected to alleged greenmail profits realised by a potential acquirer of Walt Disney Productions. The Court ruled that the plaintiffs had satisfied the initial evidential burden and the directors had failed to show that the self-purchase transaction was entered into in good faith and that it was fair to the company and its shareholders. The greenmailer was liable as an aider and abettor as it was aware of the purpose behind the transaction. Accordingly the shareholders were entitled to an injunction imposing a constructive trust on the premium paid under the greenmail transaction.

[448] If a corporate self-purchase power is introduced into Australian law, the following greenmail issues would need to be addressed:

* Should special provision be made for greenmail transactions?

* In what circumstances, if any, would it be appropriate to implement an "all holders" rule whereby the company must extend an equal opportunity to all shareholders to sell their shares in a premium self-purchase situation?

* Would potential greenmail problems be overcome by a requirement of shareholder approval or ratification of selective premium self-purchase transactions? See further [5010].

* Would the US State legislation or SEC proposals (see [442]-[444]) be an appropriate model for Australian law?

* What remedies should be available in the event of an illegal greenmail transaction? See further [5095]-[5100].

INCREASING THE RISK OF CORPORATE FAILURE

[449] A self-purchase transaction involves a distribution of corporate assets to shareholders, and to this extent increases the financial risk to creditors and remaining shareholders. Self-purchases appear to reverse the priorities between creditors and shareholders in the distribution of corporate assets, while simultaneously reducing the company's margin of financial viability.

[450] The rights of creditors and remaining shareholders could be protected in the following ways:

* Restrictions in debt covenants. Debenture trust deeds already require companies to maintain a stated balance between assets and liabilities, and such deeds may be employed to restrain the company from purchase transactions detrimental to secured creditors.

* Imposition of solvency tests as prerequisites to purchases. Companies could be prohibited from embarking on purchase transactions unless certain requirements are fulfilled: see further [5034]-[5041].

* Restrictions on the source of funds available for purchases. The effect of a self-purchase is, from the perspective of creditors, analogous to a cash dividend distribution, and accordingly the same principles and restrictions could be applied: see further [5025]-[5033].

* Provision of appeal rights by creditors and dissenting shareholders to a proposed purchase: cf Companies Code s123(3); s129(12): see further [5015]-[5018].

Chapter 5: Implementing a Self-Purchase Power

Introduction

[5001] Chapters 3 and 4 have outlined and analysed the arguments for and against the introduction of a share self-purchase power, and the issues arising therefrom. This Chapter goes further and examines the procedural questions and options that would arise if this power were implemented. The Committee emphasises that the purpose of this Chapter is to identify and discuss these implementation issues, not to pre-empt debate on the intrinsic merits of the self-purchase power.

SOURCE OF THE SELF-PURCHASE POWER

[5002] A self-purchase power could be framed in the legislation with varying degrees of restriction:

* an inherent right
* a right, subject to any contrary statement in the Memo or Articles, or
* a right only if authorised by the Memo or Articles.

Inherent Right.

[5003] The legislation could provide for a statutory based general grant of power, notwithstanding anything contained in the Memo or Articles, cf. Companies Code s129(10). This would have the attraction over the other two options of certainty and uniformity.

Right, subject to the Memo or Articles.

[5004] Under this option a company would be eligible to exercise the self-purchase power, unless an express prohibition was placed in its constitution. The Canadian

legislation adopts this approach (OBCA s30(1); CBCA s32(1)). The shareholders could prohibit the exercise of the self-purchase power by a special resolution to that effect.

Right only if authorised by the Memo or Articles.

[5005] A company could exercise the self-purchase power only if an enabling provision was found in its constitution. This is the most restrictive of the three options, but may provide the greatest protection to shareholders. This method is adopted in the UK: Companies Act s162(1); cf. Companies Code s120(1); s123(1). A further limitation could be the inclusion of a statutory sunset provision whereby any self-purchase power would lapse after a set period, unless renewed by a further special resolution.

[5006] What would be the most suitable way of framing any self-purchase power in Australian legislation?

AUTHORISATION PROCEDURE

[5007] Consideration of the procedure for empowering a company to purchase its shares raises a number of inter-related policy questions:

* Who should be authorised to exercise the power?
* What information should be provided to the decision-makers?
* What should be the terms of any authorisation?
* What appeal procedures should be available from the authorisation?
* What should be the consequences of an irregular authorization?

[5008] In determining who should be entitled to exercise these powers, a graduated range of restrictions may be identified:

* by such person or persons as authorised by each company at its discretion (Canada: in practice the board of directors);

* by ordinary resolution of the directors, with or without a right of delegation of that power (US Model Business Corporation Act);

* by super majority resolution of directors (no precedent);

* by ordinary resolution of shareholders (UK: on-market transactions); or

* by special resolution of shareholders (UK: off-market transactions).

[5009] It is not necessary that the same authorisation procedure precede every type of purchase. The legislation could vary the stipulated procedure depending upon whether the proposed self-purchase is by way of:

* on-market acquisitions
* off-market pari passu offers, or
* off-market selective self-purchases.

[5010] There is a strong argument that at least in respect of selective self-purchases (if allowed for in the legislation) a more restrictive option should be adopted (e.g. ordinary or special resolution of shareholders, excluding the vendor shareholder and its associates) to counter the possibilities of internal inequities (see [404]-[405]) and greenmail (see [425]-[448]): cf. CASA s12(g). Conversely a less restrictive procedure (e.g. an ordinary resolution of directors) might be suitable for on-market or pari passu purchases where the dangers of these abuses are reduced. This would provide companies with greater flexibility to purchase their shares on-market at optimal times and rapidly respond to changing conditions in the securities market.

[5011] The benefit of flexibility is also recognised in the EEC Second Directive Article 19, which allows the laws of the member States to dispense with the stipulated procedure (shareholder approval) where the purchase "is necessary to prevent serious and imminent harm to the company". The Article provides that in such a case the relevant information

must be given to the next general meeting of shareholders. Would a similar provision be beneficial in Australia?

Information to the decision-makers.

[5012] The identity of the decision-makers will determine the need for any statutory provision for the supply of information. Where this power resides with directors there would be little need for statutory direction. By contrast shareholders would be unable to make a fully-informed judgement on any proposed acquisition unless supplied with detailed information on the terms of the purchase (including a copy of any contract pertaining to a selective self-purchase); the reasons for it; and its anticipated financial consequences: cf, UK Companies Act s164(6). The Companies Code s129(10)(c) identifies the information that must be supplied to shareholders in advance of any special resolution granting financial assistance. Would this provide a suitable model in the self-purchase context?

Terms of the authorisation.

[5013] The legislation could set down the necessary terms of any authorisation. For instance the EEC Second Directive Article 19 provides that the general meeting "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 authorisation is given and which may not exceed eighteen months, and, in the case of acquisitions for value the maximum and minimum consideration". These requirements are reflected in the UK Act: s164-166. No equivalent controls are found in the Canadian legislation or the US Model Business Corporation Act.

[5014] The European approach is designed to ensure that where the authorisation power rests with the shareholders, they effectively regulate the self-purchase process without impinging on its day to day exercise. This policy might be undermined if, for instance, shareholders could validly pass vaguely worded or open-ended authorisations, (e.g. "the

company shall purchase such number of its shares and, on such terms and conditions, as the directors may from time to time determine"). To avoid this possibility, would restrictions similar to those found in the EEC Second Directive be suitable? The same considerations would not apply where the authorisation power resided in the hands of the directors.

Appeal procedures from authorisations.

[5015] The provision of specific appeal rights, and the nature of their exercise, must be considered in the context of the potentially conflicting interests of the parties affected by the acquisition. From the perspective of creditors and dissenting shareholders, statutory appeal rights are a necessary protective mechanism to ensure that exercise of the self-purchase power is in conformity with the procedural requirements and not prejudicial to their legitimate interests. The procedure found in the Companies Code s129(12) (13) may attain these ends.

[5016] The benefits to creditors and dissenting shareholders of specific appeal rights must be weighed against the potential costs to the company and other shareholders.

Appeal rights introduce further complexities and potential delays in the exercise of self-purchase powers, and may jeopardise the capacity of companies to make effective and expeditious use of them. Appeal procedures may also be utilised for tactical reasons, particularly in the context of takeovers. For instance if the s129(12) (13) appeal structure were adopted without alteration, a bidder with only a minimum shareholding in a target company could appeal against and thereby further delay (taking into account the mandatory 21 day wait period) a defensive self-purchase programme, irrespective of whether this had been approved by, or was in the best interests of, the majority of target company shareholders.

[5017] Overseas legislation, apart from the UK, contains no appeal provisions specifically directed at self-purchases, but instead relies on general appeal rights. The UK Act

s176; 177 has adopted an appeal structure but it is confined to self-purchases by private companies out of capital. It has no application to self-purchases by public companies or by private companies out of profits or fresh share issues. Given these considerations, various appeal procedures could be created including:

(a) no self-purchase appeal structure, with reliance instead on existing provisions e.g. Companies Code s320; s574;

(b) a self-purchase appeal structure, but limited to specific types of self-purchases e.g. selective self-purchases: see [5046] -[5048] and/or self-purchases from various funds e.g. capital (UK): see [5031]-[5033];

(c) multiple appeal structures, differing according to the factors identified in (b); or

(d) a uniform appeal structure based on the s129(12)(13) precedent.

[5018] What appeal structure(s) would be most suitable for Australian conditions?

Consequences of an irregular authorisation.

[5019] The more complex the authorisation procedure (including the satisfaction of any source of funds and solvency tests: see [5024]-[5041], the greater the likelihood that irregularities may occur. The Companies Code s539 deals with the problem of minor procedural irregularities, and a provision similar to s129(11) may also be useful to resolve doubts on the procedure followed. However, where the breaches cannot be remedied under these provisions, further policy issues arise:

* the status of affected transactions; and
* remedies for breach.

[5020] Status of affected transactions. Prior to the introduction of the Companies Code, any transaction in breach of the prohibition on a company acquiring or financing the acquisition of its own shares was deemed illegal and void. A party could not place reliance upon or produce evidence of such a transaction either to establish a claim or sustain a defence. The courts recognised a number of exceptions to this doctrine of illegality, but nevertheless parties could unjustifiably benefit or alternatively suffer a detriment from a finding that a prohibited acquisition had taken place.

[5021] The Companies Code now deals with self-purchase transactions, but in the context of their general prohibition. Section 130(1) (b) (c) provides that the contract or transaction that affects the self-purchase is void. By contrast, irregular financial assistance transactions are voidable. On one view both self-purchase and financial assistance transactions should be treated on a uniform basis as voidable, subject to the discretionary powers and remedies found in s130(2)-(5) (13). This may be a suitable policy for selective privately negotiated self-purchases, but query whether on-market or pari passu acquisitions should be open to challenge as either void or voidable?

[5022] The interests of bona fide vendor shareholders of potentially voidable contracts might be protected by utilising the certification procedure, as it currently applies to financial assistance transactions: s130(6)-(10). Signatories to the certificate would be subject to the terms of s130(11) (12).

[5023] Remedies for breach. This matter is considered at [5092]-[5104].

FINANCIAL CONSIDERATIONS

[5024] Imprudent use of the self-purchase powers could so deplete a company's assets as to lead to insolvency, or seriously lessen its margin of financial viability. Certain

controls could be introduced to reduce this risk and further protect creditors and remaining shareholders against corporate failure:

* restrictions on the sources of funds available for self-purchases; and/or

* imposition of solvency requirements on self-purchases.

Sources of Funds

[5025] The Canadian legislation and US Model Act provide maximum scope for companies to utilise the self-purchase power by imposing no restrictions on the source of available funds. A company may finance its self-acquisitions in the same manner as it would any other commercial transactions, though subject to stipulated solvency requirements: see [5036]-[5040]; cf. s129(10).

[5026] The UK legislation is far more restrictive. It limits the available funds to:

* profits otherwise available as dividends (distributable profits);

* proceeds of a fresh issue of shares made for the purpose of the self-purchase; and

* capital (in limited circumstances).

[5027] Distributable profits. Use of distributable profits is not inconsistent with the interests of creditors. A company may lawfully reduce its assets by payment of a dividend, and should be able to make the same reduction by acquiring its shares. A share acquisition from distributable profits also adds to shareholder flexibility by providing them with a choice as to the degree of participation in a corporate cash distribution.

[5028] Although no objection could be taken to funding self-purchases out of profits, differences arise as to the

meaning of this term. profits to: The UK Act restricts distributable

"Accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital
duly made".

[5029] This contrasts with the Australian approach which, in accordance with common law principles, defines profits in a more permissive manner: (Marra Developments Ltd. v Rofe Pty. Ltd. (1977) 2 ACLR 296; Industrial Equity Ltd. v Blackburn (1977) 3 ACLR 89.) The UK definition provides creditors with greater protection, but would it be suitable to adopt this definition in Australia in the limited context of self-purchases?

[5030] Proceeds of a fresh issue of shares. The UK legislation acknowledges this as a further funding source for corporate self-purchases: Companies Act s160(1) (a); s162(2); cf. Companies Code s120(3) (b). Whether this should be allowed in Australia is problematical, given its potential as a takeover defence mechanism. For instance a company could fund a defensive self-purchase in whole or part by the issue of its shares to "white knights". Query whether this is acceptable in principle, and whether the existing fiduciary duty controls over share issues would suffice to prevent abuse?

[5031] Capital. The UK Act allows private companies to purchase their shares out of capital, though this power is circumscribed with disclosure, plebiscite and appeal procedures and solvency requirements:

* The company's Articles must authorise the purchase out of capital: s171(1).

* The company must first use all available profits or fresh issue proceeds before making any inroads into its capital: s171; s172.

* The directors must make a statutory declaration of solvency, accompanied by an auditor's report: s173(3)-(5).

* The payment out of capital must be approved by a special resolution of shareholders, excluding any votes by vendor shareholders: s173(2); s174.

* Following the resolution, the proposed payment must be publicly notified: s175.

* Dissenting members and creditors may apply to the court for cancellation of the resolution: s176; s177.

[5032] If a private company purchases its shares out of capital but goes into liquidation within one year of the date of purchase, then -

* the vendor shareholders (up to the amount of their share of the capital payment) and the directors of the company who signed the necessary

* statutory declaration, other than those who show that they had reasonable grounds for forming the opinion set out in the statutory declaration,

may be liable to meet the company's outstanding debts and costs on winding-up: s504.

[5033] The right of a private company to utilise capital was justified on the basis that otherwise some companies may be unable to use the self-purchase powers. There may be less strength in this rationale in Australia, given the more permissive interpretation of profits.

Solvency Requirements

[5034] A further or alternative means of reducing the financial risks to creditors and remaining shareholders would

be to introduce a solvency requirement as a stipulated prerequisite to corporate self-purchases. This raises the following issues:

(i) Should there be a solvency test in addition to or in lieu of controls over the sources of funds available for self-purchases? The Australian legislation could provide for any of the following alternatives:

* impose both a source of funds restriction and an express solvency requirement for all self-purchases;

* maintain a general source of funds restriction and attach an express solvency requirement only to a particular source of funds e.g. self-purchases out of capital (the UK approach);

* further limit the sources of funds available for self-purchases (e.g. confine to distributable profits and the proceeds of fresh share issues) and omit any solvency requirement; or

* desist with any restrictions on sources of funds, but impose a solvency requirement on all self-purchases (e.g. Canada; the US Model Business Corporation Act).

(ii) If a solvency test is applied to all or some self-purchases, what form should it take?

[5035] A distinction can be drawn between the equity and bankruptcy definitions of insolvency. The equity definition equates insolvency with a corporation's inability to pay debts and liabilities as they become due. The bankruptcy definition equates insolvency with an excess of the company's liabilities over the realisable value of its assets. These differing concepts are, to varying degrees, reflected in existing self-purchase legislation.

[5036] The Canadian legislation applies both an equity and bankruptcy definition so that if either test of insolvency applies, the corporation is barred from purchasing its shares: CBCA s32(2), OBCA s30(2); 31(3). The UK legislation focuses on the equity definition: s173(3) (a) (b), while analogous Australian legislation dealing with financial assistance for the purchase of shares applies a broad based bankruptcy test: s129(10) (c).

[5037] The US Model Business Corporations Act s45 imposes a double solvency requirement on corporate self-purchases:

* an equity insolvency test, and
* a balance sheet test.

[5038] The Model Act prohibits self-purchases if the corporation is, or as a result of the proposed purchase would become, insolvent in the equity sense. In making this determination, the directors are required to make certain judgements as to the future course of the corporation's business, including the likelihood (based on existing and contemplated demand for the corporation's products or services) that it will be able to generate funds from its operations or from any contemplated orderly disposition of its assets sufficient to satisfy its existing and reasonably anticipated obligations as they mature. (For further details see The Business Lawyer Vol. 34 (1979) p1881-83.)

[5039] The balance sheet test, as introduced in 1980, requires that, after giving effect to any distribution, the corporation's assets equal or exceed its liabilities and liquidation preferences on senior

equity. In making this judgement the directors may rely on opinions, reports or statements including financial statements and other financial data prepared or presented by public accountants or others. (For further details see The Business Lawyer Vol. 34 (1979) p1883-85.)

[5040] The Model Act recognises the need to specify the time at which the two tests imposed by s45 should be measured. Accordingly, where shares of the corporation are acquired by it, the date approximating the earlier of the payment date or the date the shareholder ceases to be a shareholder with respect to such shares is to be used as the measuring date.

[5041] Query which solvency test or tests should be utilised for corporate self-purchases?

(iii) What remedies should be available in the event of an insolvent self-purchase? Note the UK provisions: [5032] and see further [5101]-[5104].

METHOD OF PURCHASE

[5042] A company could purchase its shares by:

* on-market acquisitions (for listed public companies);
* off-market pari passu offers;
* off-market tender offers from shareholders;
* selective (privately negotiated) purchases;
* mandatory acquisitions.

Which of these procedures should be allowed for in any Australian legislation?

On-market acquisitions.

[5043] This would appear to be a suitable method of acquisition provided all shareholders have an equal opportunity of participation. This might be achieved by requiring that all shareholders receive adequate notice of

the forthcoming self-purchase: see further [5064]-[5069]. Without prompt disclosure, some shareholders might unfairly benefit from advance knowledge of the self-purchase (e.g. those shareholders who attended the authorisation meeting).

Off-market pari passu offers.

[5044] This method of self-purchase provides shareholders with the choice between a cash return (by selling) and an increased share of ownership (by retaining their shares). A company could pro-rata excess acceptances where its resulting self-entitlement is less than 20% of its shares; above that threshold it would be obliged to conduct a full or proportional partial bid.

Off-market tender offers from shareholders.

[5045] A novel repurchase method was found in the old Ontario legislation (1970). It provided for self-purchases to be made "by invitation addressed to all shareholders for tenders of shares and pro-rata from the shares so tendered". The shareholders individually, rather than the company, would tender a selling price and the company was obliged to buy at "the lowest price at which, in the opinion of the directors, such shares are obtainable". This provision was not included in the current Ontario legislation. It is doubtful whether this would be a suitable method of self-purchase for Australia, given the lack of information by many shareholders as the true value of their shares, and the opportunities for insider trading that could arise.

Selective self-purchases.

[5046] There may be valid commercial reasons for companies wishing to enter into purchase agreements with particular shareholders. However these selective transactions provide the opportunity for greenmail and other forms of discrimination between shareholders. These potential abuses may be lessened by:

* limiting the circumstances in which selective self-purchases may be made; and/or

* imposing a restrictive authorisation procedure.

[5047] Possible instances where selective self-purchases might be permitted are:

* to settle or compromise a bona fide debt due to the company by a shareholder
* to eliminate fractional shares
* to fulfill the terms of an employee share scheme
* to honour shareholder liquidity agreements in closely held companies
* to comply with a court order.

[5048] The alternative or additional protection would be to impose controls through the authorisation procedure. Various shareholder approval proposals have been put forward in the USA, applicable to selective self-purchases at a premium to market price: see [442]-[444]. Would it suffice to allow companies to enter into selective self-purchases, but only upon the authority of the shareholders excluding the vendor shareholder and its associates; if so should this be by ordinary or special resolution? See also [5009]-[5010].

Mandatory self-purchases.

[5049] Should any self-purchase legislation empower companies to compulsorily acquire their shares? Currently companies can achieve this end by means of a formal reduction of share capital pursuant to the terms of s123 of the Companies Code. The question is whether to provide companies with an alternative avenue for a compulsory reduction of capital.

[5050] There appears to be strong policy reasons against this extension:

* the mandatory acquisition power is already available under s123, and to that extent a similar power in any self-purchase legislation would be redundant;

* its inclusion in the self-purchase provisions would attract the need for greater authorisation controls and judicial involvement in the acquisition process;

* the self selectivity inherent in voluntary purchases adds considerable flexibility to shareholder decision-making and this may be lost with compulsory acquisitions.

Arguably, on these grounds any legislation should be confined to voluntary transactions.

TYPE, VOLUME, PRICE AND TIMING CONTROLS ON SELF-PURCHASES

[5051] Should only fully paid shares be capable of acquisition? The principal argument for this limitation is that to allow partly paid shares to be purchased may result in the company further subsidising the price of its shares. In addition, if the acquired shares are not cancelled but held as treasury shares (assuming this is allowed for in the legislation), this may give the false impression that someone other than the company remains liable for the unpaid balance on the shares. These potential problems could be overcome by prohibiting the purchase of partly paid shares: see UK Companies Act s162 (2); s159 (3); cf. Companies Code s120 (2)(c).

Volume

[5052] There are various controls which could be imposed on the number of its shares a company may acquire:

* minimum membership requirements
* maximum on-market acquisitions within a given period
* maximum total acquisitions as a proportion of the company's share capital.

[5053] Minimum membership requirement. Australian companies, except for wholly-owned subsidiaries, must have a minimum membership of two shareholders (proprietary companies) or five shareholders (public companies): s82. It

would be consistent with this principle to prohibit any self-purchase which may result in a company having fewer than the statutory minimum membership. However would a specific provision in this context be necessary?

[5054] The UK Companies Act s162(3) further prohibits self-purchases if, as a result, there would be no members other than the holders of redeemable shares. A similar provision may be suitable.

[5055] Maximum on-market acquisitions within a given period. As a preventive measure against acquiring companies dominating the market turnover and thereby the price of their shares, controls have been introduced both in the UK and USA on the volume of on-market purchases within a given time period. The London Exchange prohibits a listed company from buying 15% or more of its shares within any twelve month period except by way of a general or partial tender offer to all shareholders. The US Rule 10b-18 places limits on the daily volume of on-market purchases, being a maximum of 25% of the trading volume of that security, defined as the average daily trading volume in the security over the four calendar weeks preceding the week in which the repurchases are made. Breach of Rule 10b-18 does not result in a statutory violation; rather the acquiring company forfeits any immunity from possible liability for market manipulation.

[5056] Would the principles underlying either the London Exchange or US Rule be suitable for Australian Exchanges?

[5057] Another suggested volume control is that on-market purchases be subject to limits on the size of parcels to ensure that small holders have a chance to sell their shares and that no crossing or specials be allowed. Would such controls be useful?

[5058] Maximum total acquisitions as a proportion of the company's share capital. The EEC Second Directive Article 19 states that the number of shares a company may acquire and

hold as treasury shares may not exceed 10% of its subscribed capital. The apparent purpose behind this rule is to restrict the extent to which self-purchases might be used to enhance the position of a company's control group or increase the value of their shares. Would a rule of this nature perform any useful function in Australia, given the 20% entitlement threshold of CASA?

Price

[5059] The capacity of listed companies to purchase their shares on-market provides them with a means of directly influencing the market price: see [406]. To counter possible abuses, the London Exchange stipulates that for all self-purchases other than pursuant to a tender offer, the buying price must be no more than 5% above the average of the middle market quotation in those shares for the ten business days prior to the purchase. The US Rule 10b-18 states that in order for companies to enjoy the immunity protection, the price paid by them must not exceed the higher of either the highest current independent published bid or the last independent sale price reported in the Exchange system.

[5060] Would the London or US Rule, or some other price control formula, be appropriate for on-market self-purchases in Australia?

[5061] A separate pricing issue concerns the means of valuing shares the subject of off-market self-purchases. Without some controls, shares may be substantially under or over valued, thereby discriminating between participating and non-participating shareholders and in some instances unnecessarily draining the funds of the company. Given this possibility, a number of options are open:

* leave this issue to be resolved in accordance with existing fiduciary duty principles; (Would this suffice to overcome the potential conflict of interest between the company and the vendor shareholder(s)?)

* require that directors provide shareholders with sufficient information to allow them to arrive at a reasonable estimation of the true value of their shares; or introduce an independent share valuation mechanism, cf. CASA s23.

Timing

[5062] The timing of on-market purchases may have a significant impact on their market price. US Rule 10b-18 seeks to counter the possible distorting effects of early or late market trading by denying the issuer or its affiliates the right to purchase their shares on any given day until there has been an independent transaction in those shares; nor may they buy their shares during the last half hour of trading on the exchange. Consideration might be given to introduction of a similar rule for Australian Exchanges.

[5063] The London Exchange has a wider rule whereby a company may not purchase its shares in the two months immediately preceding the announcement of its annual or half-yearly results. This is designed to inhibit the possibility of companies either themselves engaging in insider trading or intentionally or inadvertently arousing market speculation over these results and their share price implications. Would a similar restriction be desirable in Australia?

MARKET DISCLOSURE OF INTENDED SELF-PURCHASES

[5064] Inclusion of a market disclosure requirement as a pre-condition to on-market self-purchases could achieve the following results:

lessen the possibility of market price manipulation: see [406]-[410]; diminish the opportunities for insider trading: see [411]-[414];

counter the problem of internal inequities: see [404]-[405]; and allow shareholders and potential investors to make more fully informed investment decisions.

[5065] In the USA, the SEC Rules 13e-1 and 13e-4 impose advance disclosure obligations on take-over targets which intend either to purchase any of their own shares or conduct a self-tender: see [239]-[241]; [245].

[5066] A possible drawback with an advance disclosure policy is that it might limit the company's capacity to acquire shares at optimal times and also generate share speculation in anticipation of the purchase. These factors would need to be taken into account in determining the minimum length of a mandatory notice period.

[5067] The information required to be disclosed could encompass all or some of the following:

* the identity of the company as the intended purchaser and of any nominees or associates to be involved in the acquisition;
* the identity of the intended broker (note the US Rule 10b-18 which limits the company and its affiliates to the use of one broker or dealer to solicit purchases during any single day);
* the terms and conditions of the self-purchases including the maximum number of shares to be acquired; the maximum consideration to be offered; and the duration of the purchase period;
* the reasons for the acquisition;
* the dates and prices of self-purchases within the previous (say) 12 month period;
* the anticipated effect of the purchase, if successful, on the future funding and profitability of the company;
* the source and amount of funds to be used in the purchase;

* the substance of information held by the company which is relevant to determining the true value of the shares;
* whether the acquired shares are to be cancelled or held as treasury shares (if this option is allowed for in the legislation);
* whether the purchase, if successful, would have any effect on the listing of the company's securities (see SEC Rule 13e-3: [244]).

[5068] The company could be required to notify changes, by way of an amended disclosure document, within a stipulated time, up to the end of the purchase period. Penalties for breach could be included.

[5069] This gives rise to the following questions:

* Should provision be made for a mandatory market disclosure document, and if so, what information should it contain?
* Should the disclosure document be either registered or lodged with the NCSC prior to its distribution? (Registration would involve an evaluation of its contents, cf. Companies Code s103; CASA s18.)
* To whom should the disclosure document be made available; the Stock Exchanges; all shareholders? Should companies be required to provide a media notice?
* Should there be a compulsory wait period, and if so of what length, between the publication of the disclosure document and the commencement of purchasing?
* Would the existing CASA Part A; Part C disclosure requirements suffice where a company undertakes a self-bid (assuming the legislation allows for self-tenders)? The London Code Rule 37.4(b) requires an on-market offeror to disclose its self-purchases within the previous 12 months, including details of acquisition dates and prices.

* What mechanism, if any, should be provided whereby companies may seek exemption from particular disclosure provisions? Should the legislation identify possible grounds of exemption?
* What civil remedies should be available in the event of a material misstatement or omission in the disclosure document? (See further [5100])

DISCLOSURE OF COMPLETED TRANSACTIONS

[5070] It would be consistent with the principle of a fully informed market that companies be required to disclose substantial acquisitions of their own shares, as well as those of other companies. The Companies Code Part IV Division 4 and CASA s39 impose notification obligations which, in principle, should apply equally to self-purchases, if this power is introduced. However, given the potential impact of self-purchases both for the market and within the company, should acquiring companies, unlisted as well as listed, be subject to further disclosure obligations, to cover situations where the above provisions do not apply?

[5071] The London Exchange requires listed companies to notify it of all self-purchases, regardless of size, and details of prices paid, by midday of the following business day. This might be a suitable rule for companies listed on Australian Exchanges.

[5072] In addition the UK Companies Act s169 creates specific disclosure requirements for all companies, regardless of whether the transactions are on-market or off-market. It may be preferable to follow this precedent in any Australian legislation and establish a separate self-purchase register with stipulated times for entry and information provisions, rather than graft self-purchase transactions onto existing share register provisions (such as are found in Part V Division 4 of the Companies Code). Provision could be made for inclusion of register details in the company's annual report.

STATUS OF SELF-PURCHASED SHARES

[5073] A number of policy alternatives are available for the classification of these shares. They could be treated as:

* Treasury shares; or
* Cancelled shares

Treasury shares.

[5074] This classification was employed in the US Model Business Corporation Act prior to the 1980 amendments. A self-purchase did not reduce the number of issued shares or the issued share capital, nor did the resale of these shares increase the number of issued shares or the amount of issued capital. Instead, during the period that they were held by the company as issued but unallotted shares available for resale, they remained in a dormant form without voting or dividend rights. This formula was criticised as both fictitious (a company holding a claim against itself) and confusing and has been replaced in the Model Act. However the laws in many states of the USA retain this treasury share concept.

[5075] This classification is not unknown in Australian company law. Shares forfeited for non-payment of calls or installments are treated as issued, and may be resold or disposed of as the directors think fit (Table A Reg. 28) or in the case of shares in no liability companies, by auction: Companies Code s479. Until resold, forfeited shares in no liability companies are held by the directors in trust for the company but carry no voting rights: s480(3); see also AASE Listing Rule 3P.

Cancelled Shares.

[5076] The UK legislation provides that shares which are purchased by the company must be cancelled, and the amount of the company's issued capital diminished by the nominal value of the shares acquired: s162(2); s160(4). The purchase does not reduce the company's authorised share capital, cf. Companies Code s123(1)(2). Cancelled shares shall constitute authorized but unissued capital (except where the company has already issued all of its authorized capital). The benefit of this approach is that it avoids the accounting and resale problems which dealings in treasury shares may involve.

[5077] By amendments introduced in 1980, the US Model Business Corporation Act (s6) provides that all self-purchased shares shall be treated as authorised but unissued shares, unless the company's Articles prohibit their reissue, whereupon the authorized share capital shall be reduced by the number of shares acquired. The Canadian legislation has similar provisions (CBCA s37(5); OBCA s35(6)). Unissued shares, by definition, carry no voting or dividend rights and this avoids the need to make specific provision suspending such rights for reacquired shares.

[5078] Matters for consideration:

* What would be the most appropriate status for self-purchased shares?
* Should this be settled by legislation or left to the determination of companies?
* If self-purchased shares may be held as treasury shares, what controls, if any, (in addition to the Companies Code s552) are required over their resale?

[5079] The classification of self-purchased shares as cancelled may necessitate amendment to some key provisions of the Companies and Securities legislation. For instance CASA s11 and the Companies Code Part IV Division 4 (substantial

shareholdings) apply only to voting shares, which as defined (Companies Code s5(1)) exclude unissued shares. A company might acquire a majority of its shares free of the CASA provisions through a series of discrete 'small bite' acquisitions, each for less than 20% of the outstanding (i.e. non cancelled) issued share capital. Clearly it would be anomalous if companies could purchase their shares in this manner, oblivious to these takeover and disclosure provisions. One possible solution would be to provide that for the purpose of these and other relevant sections (e.g. CASA s39) self-purchased shares shall, for a stipulated period, be treated as issued voting shares held by the company.

EXECUTORY AND PARTIALLY PERFORMED CONTRACTS

[5080] Companies may, for good reason, enter into conditional, installment based or optional self-purchase contracts (e.g. shareholder liquidity plans). It is possible that at the maturity date of any such contract, or during the course of a partially completed installment agreement, the company is unable to honour its commitments. Questions then arise as to the status and enforceability of these contracts and the rights of other affected parties e.g. creditors; remaining shareholders.

[5081] The Canadian legislation (CBCA s38; OBCA s36) provides that executory contracts are specifically enforceable against the corporation, except where this would result in a company's breach of its statutory solvency requirements. The section stipulates that in any action to enforce an executory contract, the corporation carries the burden of proof that performance of the contract is prohibited under the statute. However, such contracts are not rendered void or unenforceable. The Act provides that until the contract is fully performed, the shareholder will be regarded as a claimant entitled to be paid as soon as this is lawful. In the event of intervening liquidation, the

claimant shareholder will be ranked subordinate to creditors but in priority to other shareholders.

[5082] The UK Act contains detailed provisions regulating both the creation and enforcement of executory contracts. Contingent purchase contracts must be approved in advance by special resolution of the company: s165; a company is prohibited from assigning its rights under such contracts; s167(1) and any agreement releasing the rights of the company under the contract must be approved in advance by special resolution: s167(2).

[5083] In the event that a company fails to honour an executory contract, the contractual rights of the vendor shareholder are preserved. However the company is not liable in damages, nor may the court grant an order for specific performance where the company shows that it is unable to meet the acquisition costs out of distributable profits: s178(2) (3). Where, at the commencement of a winding up, an executory contract remains outstanding, it may still be enforced against the company, though subject to rights of creditors and any stipulated preferred rights of shareholders: s178(4)(6). However this enforcement right applies only if the contract is then current and enforceable and the company could have, at some time between the contractual completion date and the commencement of winding up, lawfully made a distribution equal in value to the contract price: s178(5). An executory contract with a maturity date later than the commencement of winding up cannot be enforced.

[5084] Australian courts have examined the status of executory contracts within the analogous context of redemption of redeemable preference shares, but without the benefit of statutory direction: ire Marra Developments Ltd. (No 2) (1978) 3 ACL. 798; FCT v Coppleson (1981) 34 ALR 377; 6 ACLR 428). This seems a less satisfactory approach than including specific guiding provisions in the legislation. These might be modelled either on the Canadian or UK precedents.

SELF-PURCHASE RELATED DEBT

[5085] In acquiring its shares, a company may, as an alternative to paying cash or other consideration, prefer to incur a debt to the former shareholder. The status of any outstanding indebtedness needs to be clarified if the company later goes into liquidation.

[5086] The US Model Business Corporation Act s45 contains two governing principles:

* Such debts are treated as on a parity with those of unsecured creditors, though they may be subordinated by agreement. The stated rationale is that unsecured creditors are better off in this situation than they would have been if cash or other property had been paid out for the shares, and no worse off than if assets had been paid out to the shareholder, who had then promptly loaned them back to the corporation and thereby become a creditor.

In applying the solvency tests in the Act: see [00] the legality of a distribution under this provision will be measured at the time of incurring the debt (i.e. when the share purchase took place), not at a later date when the debt is actually paid. A payment that is made in consequence of a self-purchase that satisfies the solvency tests at the time of incurring of the debt is valid, notwithstanding a subsequent insolvency, though it could constitute a preferential payment amongst creditors.

[5087] In the UK this problem is overcome by requiring companies to pay for the shares at the time of their acquisition: s159(3); s162(2). Self-purchase related debts are prohibited.

[5088] From this the following issues arise:

* Should Australian legislation prohibit or alternatively allow for self-purchase related debts?

* In the event that they are permitted, would the US provisions be necessary or suitable?

CASA: SECTION 11 IMPLICATIONS

[5089] Self-purchases will increase the proportion of issued capital held by non (or lesser) participating shareholders. As a result companies may be unfairly prevented from acquiring their shares by the operation of s11. This section prohibits "a person" (the company) from acquiring shares if the entitlement of "any person" (e.g. one or more non-participating shareholders) would exceed the 20% threshold. A self-purchase may result in the entitlement of one or more non-participating shareholders crossing this threshold or increasing within the 20-90% shareholding range. A blanket ban on corporate self-purchases in these circumstances (other than under the s12-17 exceptions), regardless of the number of shares held or sought by the company, or the relationship between the company and the shareholder(s), appears to exceed the underlying policy of the legislation.

[5090] A possible solution is offered by the London Code Rule 37.1. This Rule focuses on changes to the shareholding entitlement of the directors and affiliates of the acquiring company. It provides that where a company purchases its own voting shares, a resulting increase in the percentage voting rights carried by shareholdings of the directors and persons acting in concert with them shall be treated as an acquisition for the purposes of Rule 9 (the takeover threshold: cf. CASA s11). This rule might be adapted to CASA to provide that in respect of self-purchases the phrase "any person" and "relevant person" in s11(1)(2) shall be limited to, say, the acquiring company and its associates. This may overcome artificial barriers to corporate self-

purchases caused by s11, while maintaining the CASA regulatory framework where corporate controllers seek to increase their own shareholdings through such acquisitions.

[5091] The problem of applying CASA principles to cancelled shares is discussed at [5079].

CRIMINAL LIABILITY

[5092] Currently the Companies Code s129(5) imposes criminal liability on various parties, should a company unlawfully acquire its own shares. Introduction of a self-purchase power would alter the focus of criminal sanctions from prohibition to procedural breaches such as:

* the information required to be disclosed to the decision makers was false, incomplete or misleading in a material particular;

* the self-purchase breached a financial requirement (e.g. an applicable solvency test);

* the stipulated self-purchase procedure was not otherwise complied with;

* the mandatory disclosure documents were false, incomplete or misleading in a material respect; or

* a self-purchase took place in breach of one or more of the authorisation conditions.

[5093] Given this, are the terms of s129(5) suitable and adequate, when considered in combination with any default liability that may be attached to the disclosure provisions, and other applicable provisions of the Companies and Securities legislation?

Company immune from criminal liability.

[5094] Under s129(5), the company is no longer deemed to have committed a criminal offence. The Eggleston Committee Fifth Interim Report (para 94) pointed out that if the real object of the self-purchase prohibition was to protect creditors and remaining shareholders, little would be

achieved by imposing a criminal penalty on the company. This principle would appear equally applicable to procedural breaches of the self-purchase power.

Criminal penalties for defaulting officers.

[5095] Under s129(5) each officer of the company who is in default is guilty of an offence. "Officers" are broadly defined under s5(1) of the Companies Code to include any director (as defined in s5(1)), secretary, executive officer (as defined in s5(1)) or employee of the company. The term "officer in default" is defined in s572 of the Companies Code as "any officer of the corporation (including a person who subsequently ceased to be an officer of the corporation) ... who is any way, by act or omission, directly or indirectly, knowingly concerned in or party to the contravention or failure". These provisions, when combined with the terms of s563 and s564 of the Companies Code may be an adequate response to procedural breaches of the self-purchase powers (except, possibly, self-purchases in breach of the authorisation conditions).

[5096] The actions of directors may also involve them in criminal breaches of their fiduciary duties. For instance, directors would be in breach of s229 of the Companies Code if, in preparing their statements to shareholders, they acted dishonestly or without a reasonable degree of care and diligence. The legislation should make clear that any subsequent shareholder ratification of the self-purchase does not immunise directors from such liability; cf. s129(15).

Liability of other parties.

[5097] The Companies and Securities (Interpretation and Miscellaneous Provisions) Act s38(1) provides that "a person who aids, abets, counsels or procures or by act or omission is any way directly or indirectly knowingly concerned in or party to, the commission of an offence against any relevant Act shall be deemed to have committed that offence and is punishable accordingly". This provision would apply to any vendor shareholder knowingly involved in a procedural breach

e.g. a greenmailer acting in collusion with company directors to deceive shareholders on the reasons for, or terms of, the selective self-purchase. No further or alternative provisions would appear necessary.

CIVIL REMEDIES

[5098] civil recovery rights provide both a disincentive against, and protection from the detrimental effects of, criminal or otherwise illegal behaviour. Would these objectives be met adequately if the existing civil remedies in the Companies and Securities legislation were applied to self-purchase transactions?

Existing civil remedies.

[5099] Section 129(6) provides that where a person is convicted of an offence under s129(5), or under s38(1) of the Interpretation and Miscellaneous Provisions Act, the criminal court may, in addition to imposing a criminal penalty, order the convicted person to pay compensation to the company or another person who has suffered loss or damage as a result of the contravention. Section 130(4)(5)(13) provide the court with wide remedial powers, limited only by the protection afforded to holders of certificates of compliance. Under s229(6), the company is entitled to compensation against officers in breach of their statutory fiduciary duties, while a potentially wide-ranging compensation right is found in s574 (8).

Possible civil actions.

[5100] A range of civil claims are conceivable:

(i) The company (either itself, through the liquidator or in a derivative shareholder action) against directors, for abuse of their powers.

Remedies would be available under s129(6); s130(4) (5) s229 (6) and s574 (8). Section 129 (15.) overcomes any suggestion that an authorisation procedure involving shareholders supersedes the duties of directors or

constitutes a form of ratification of possible fiduciary duty breaches. Query whether a further civil remedy is needed to cover self-purchases in breach of the authorisation conditions?

(ii) The company against the vendor shareholders for recovery of funds paid. In this context two quite different situations may be considered:

* A civil action against a vendor shareholder party to the breach. In this instance s129 (6); s130 (4) (5) and s574 (8) would apply. The defaulting vendor shareholder would enjoy no immunity from holding a certificate of compliance: s130 (7) (8).

* A civil action against bona fide vendor shareholders. Where the transactions take place on-market or pursuant to a general pari passu offer, query whether any civil remedies should be available. With selective self-purchases, should innocent vendor shareholders be entitled to utilise the certification procedure under s130(6) to avoid civil liability?

(iii) Vendor shareholders against the authors of misleading information in the mandatory disclosure document.

There may be a case for introducing civil remedies drafted, possibly, on the lines of the Companies Code s107 (Civil Liability for Untrue Statements or Non Disclosures in a Prospectus). Alternatively s129 (6) and s130(4)(5) could be utilised.

(iv) Non-participating shareholders against the authors of the misleading disclosure document.

Shareholders may determine, on the basis of false or misleading information, not to sell their shares. They might later claim damages for lost opportunities. A provision based on s107 would be ineffective in this context as it does not apply to non-participants. Theoretically s129(6) and s130(4) (5) are applicable, but it would be necessary to establish that claimants had suffered "loss or damage ... as a result of" the contravention. This causation restriction may be necessary to avoid an undue extension of civil liability. A further remedy may be available under s574(8).

Civil recovery upon insolvency

[5101] The final matter is whether, independently of the above, there should be a separate civil remedy where self-purchases have taken place in breach of any statutory solvency requirements. This raises the general question of the balance of interest between vendor shareholders, creditors, and remaining shareholders.

[5102] A recovery right would provide much greater protection to creditors and remaining shareholders and to this extent lessen˜ one of the principal objections to corporate self-purchases. The UK Companies Act s504 provides that where a company purchases its shares out of capital and then goes into liquidation within one year of the date of purchase, the vendor shareholders and the directors of the company who signed the necessary statutory declaration are liable to compensate the company. Vendor shareholders must˜ reimburse their share of the capital payment, while directors are jointly and severally liable with all the shareholders concerned.

[5103] The argument against granting a recovery right is that it may create too many uncertainties and procedural complexities, particularly if a solvency requirement is

attached to all self-purchases, including on-market acquisitions. On-market vendor shareholders may find themselves at risk of disgorgement, depending upon the often arbitrary factor of whether they contracted with the company or some other market purchaser. In other circumstances e.g. off-market pari passu offers or selective self-purchases, vendor shareholders would remain at risk for the duration of any stipulated solvency period.

[5104] The Companies Code s451 provides that certain dispositions of money or property by an insolvent company may be challenged in a liquidation as a voidable preference. The principles underlying this section could be applied to corporate self-purchases, though some adaptations may be necessary (e.g. under s451, which incorporates s122 of the Bankruptcy Act, the transaction must have involved a person in a creditor capacity; query whether this would cover a vendor shareholder in a self-purchase transaction). Would this provision sufficiently balance the interests of all concerned?

Appendix B

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APPENDIX 1:

UK COMPANIES ACT 1985

Chapter VII-Redeemable Shares;
Purchase by a Company of its Own Shares

REDEMPTION AND PRUCHASE GENERALLY

SEC. 159 Power to issue redeemable shares

159(1) [Power] Subject to the provisions of this Chapter, a company limited by shares or limited by guarantee and having a share capital may, if authorised to do so by its articles, issue shares which are to be redeemed or are liable to be redeemed at the option of the company or the shareholder.

159(2) [Must be issued shares] No redeemable shares may be issued at a time when there are no issued shares of the company which are not redeemable.

159(3) [Shares must be fully paid] Redeemable shares may not be redeemed unless they are fully paid: and the terms of redemption must provide for payment on redemption.

SEC. 160 Financing, etc. of redemption

160(1) [From distributable profits of company] Subject to the next subsection and to sections 171 (private companies redeeming or purchasing own shares out of capital) and 178(4) (terms of redemption of purchase enforceable in a winding up)-

(a) redeemable shares may only be redeemed out of distributable profits of the company or out of the proceeds of a fresh issue of shares made for the purposes of the redemption; and

(b) any premium payable of redemption must be paid out of distributable profits of the company.

160(2) [Premiums payable of redemption] If the redeemable shares were issued at a premium, any premium payable on their redemption may be paid out of the proceeds of a fresh issue of shares made for the purposes of the redemption, up to an amount equal to –

(a) the aggregate of the premiums received by the company on the issue of the shares redeemed, or

(b) the current amount of the company's share premium account (including any sum transferred to that account in respect of premiums on the new shares),

whichever is the less; and in that case the amount of the company's share premium account shall be reduced by a sum corresponding (or by sums in the aggregate corresponding to the amount of any payment made by virtue of this subsection out of the proceeds of the issue of the new shares.

160(3) [Redemption in accordance with articles] Subject to the following provisions of this Chapter, redemption of shares may be effected on such terms and is such manner as may be provided by the company's articles.

160(4) [Shares redeemed treated as cancelled] Shares redeemed under this section shall be treated as cancelled on redemption, and the amount of the company's issued share capital shall be diminished by the nominal value of those shares accordingly; but the redemption of shares by a company is not to be taken as reducing the amount of the company's authorised share capital.

160(5) [Extent of power to issue shares] Without prejudice to subsection (4), where a company is about to redeem shares, it has power or issue shares up to the nominal value of the shares to be redeemed as if those shares had never been issued.

SEC. 161 Stamp duty on redemption of shares

161(1) [Chargeable transaction under sec. 47, Finance Act 1973] For the purposes of section 47 of the Finance Act 1973, the issue of shares by a company in place of shares redeemed under section 160 constitutes a chargeable transaction if, and only if, the actual value of the shares so issued exceeds the value of the shares redeemed at the date of their redemption.

161(2) [Amount of stamp duty under sec. 47(5), 1973 Act] Where the issue of the shares does constitute a chargeable transaction for those purposes, the amount on which stamp duty on the relevant document relating to that transaction is chargeable under section 47(5) of the Finance Act 1973 is the difference between-

(a) the amount of which that duty would be so chargeable if the shares had not been issued on place of shares redeemed under section 160; and

(b) the value of the shares redeemed at the date of their redemption.

161(3) [Shares issued by a company under sec. 161(1), (2)] Subject to the following subsection, for the purposes of subsections (1) and (2) shares issued by a company-

(a) up to the nominal amount of any shares which the company has redeemed under section 160; or

(b) in pursuance of section 160(5) before the redemption of shares which the company's about to redeem under that section,

are to be regarded as issued in place of the shares redeemed or (as the case may be) about to be redeemed.

161(4) [Shares issued in pursuance of sec. 160(5)] Shares issued in pursuance of section 160(5) are not to be regarded for purposes of subsection (1) and (2) of this section as issued in place of the shares about to be redeemed, unless those shares are redeemed within one month after the issue of the new shares.

SEC. 162 Power of company to purchase own shares

162(1) [Power] Subject to the following provisions of this Chapter, a company limited by shares or limited by guarantee and having a share capital may, if authorised to do so by its articles, purchase its own shares (including any redeemable shares).

162(2) [Application of sec. 159 to 161] Sections 159 to 161 apply to the purchase by a company under this section of its own shares as they apply to the redemption of redeemable shares, save that the terms and manner of purchase need not be determined by the articles as required by section 160(3).

162(3) [Limitation on purchase] A company may not under this section purchase its shares if as a result of the purchase there would no longer be any member of the company holding shares other than redeemable shares.

SEC. 163 Definitions of "off-market" and "market" purchase

163(1) ["Off-market" purchase] A purchase by a company of its own shares is "off-market" if the shares either-

(a) are purchased otherwise than o a recognised stock exchange, or

(b) are purchased on a recognised stock exchange but are not subject to a marketing arrangement on that stock exchange.

163(2) [Interpretation of sec. 163(1)] For this purpose, a company's shares are subject to a marketing arrangement on a recognised stock exchange if either-

(a) they are listed on that stock exchange; or

(b) the company has been afforded facilities for dealing in those shares to take place on that stock exchange without prior permission for individual transactions from the authority governing that stock exchange and without limit as to the time during which those facilities are to be available.

163(3) ["Market" purchase] A purchase by a company of its own shares is a 'market purchase' if it is a purchase made on a recognised stock exchange, other than a purchase which is an off-market purchase by virtue of subsection (1)(b).

SEC. **164 Authority for off-market purchase**

164(1) [Limitation of off-market purchase] A company may only make an off-market purchase of its won shares in pursuance of a contract approved in advance in accordance with this section or under section 165 below.

164(2) [Authority for proposed contract] The terms of the proposed contract must be authorised by a specific resolution of the company before the contract is entered into; and the following subsections apply with respect to that authority and to resolutions conferring it.

164(3) [Variation etc. of authority] Subject to the next subsection, the authority may be varied, revoked or from time to time renewed by special resolution of the company.

164(4) [Authority for public company] In the case of a public company, the authority conferred by the resolution must specify a date on which the authority is to expire; and in a resolution conferring or renewing authority that date must not be later than 18 months after that on which the resolution is passed.

164(5) [Special resolution not effective in certain cases] A special resolution to confer, vary, revoke or renew authority is not effective if any member of the company holding shares to which the resolution relates exercises the voting rights carried by any of those shares in voting on the resolution and the resolution would not have been passed if he had not done so.

For this purpose-

(a) a member who holds shares to which the resolution relates is regarded as exercising the voting rights carried by those shares not only if he votes in respect of them on a poll on the question whether the resolution shall be passed, but also if he votes on the resolution otherwise than on a poll;

(b) notwithstanding anything in the company's articles, any member of the company may demand a poll on that question; and

(c) a vote and a demand for a poll by a person as proxy for a member are the same respectively as a vote and a demand by the member.

164(6) [copy of contract or terms to be available for inspection] Such a resolution is not effective for the purposes of this section unless (if the proposed contract is in writing) a copy of the contract or (if not) a written memorandum of its terms is available for inspection by members of the company both-

(a) at the company's registered office for not less than 15 days ending with the date of the meeting at which the resolution is passed, and

(b) at the meeting itself.

A memorandum of contract terms so made available must include the manes of any members holding shares to which the contract relates; and a copy of the contract so made available must have annexed to it a written memorandum specifying any such names which do not appear in the contract itself.

164(7) [Limited on variation of existing contract] A company may agree to a variation of an existing contract so approved, but only if the variation is authorised by a special resolution of the company before it is agreed to; and subsections (3) to (6) above apply to the authority for a proposed variation as they apply to the authority for a proposed contract, save that a copy of the original contract or (as the case may require) a memorandum of its terms, together with any variations previously made, must also be available for inspection in accordance with subsection (6).

SEC. **165 Authority for contingent purchase contract**

165(1) [Contingent purchase contract] A contingent purchase contract is a contract entered into by a company and relating to any of its shares-

(a) which does not amount to a contract to purchase those shares, but
(b) under which the company may (subject to any conditions) become entitled or obligated to purchase those shares.

165(2) [Approval in advance] A company may only make a purchase of its own shares in pursuance of a contingent purchase contract if the contract is approved in advance by a special resolution of the company before the contract is entered into; and subsections (3) to (7) of sections 164 apply to the contract and its terms.

SEC. **166 Authority for market purchase**

166(1) [Authority by company in general meeting] A company shall not make a market purchase of its won shares unless the purchase has first been authorised by the company in general meeting.

166(2) [Types of authority] That authority-

(a) may be general for the purpose, or limited to the purchase of shares of any particular class of description, and
(b) may be unconditional or subject to conditions.

166(3) [Requirements of authority] The authority must-

(a) specify the maximum number of shares authorised to be acquired.
(b) Determine both the maximum and the minimum prices which may be paid for the shares, and
(c) Specify a date on which it is to expire.

166(4) [Variation, revocation, renewal of authority] The authority may be varied, revoked or from time to time renewed by the company in general meeting, but this is subject to subsection (3) above; and in a resolution to confer or renew authority, the date on which the authority is to expire must not be later than 18months after that on which the resolution is passed.

166(5) [Company's purchase of own shares] A company may under this section make a purchase of its own shares after the expiry of the time limit imposed to comply with subsection (3)©, if the contract of purchase was concluded before the authority expired and the terms of the authority permitted the company to make a contract of purchase which would or might be executed wholly or partly after its expiration.

166(6) [Resolution conferring or varying authority] A resolution of a company conferring, varying, or revoking or renewing authority under this section is subject to section 380 (resolution to be sent to registrar of companies within 15 days).

SEC. **167 Assignment or release of company's right to purchase own shares**

167(1) [Prohibition of assignment] The rights of a company under a contract approved under section 164 or 165, or under a contract for a purchase authorised under section 166, are not capable of being assigned.

167(2) [Release of rights- conditions] An agreement by a company to release its rights under a contract approved under section 164 or 165 is void unless the terms of the release agreement are approved in advance by a special resolution of the company before the agreement is entered into; and subsection (3) to (7) of section 164 apply to approval for a proposed release agreement as to authority for a proposed variation of an existing contract.

SEC. 168 Payments apart from purchase price to be made out of distributable profits

168(1) [Types of payment] A payment made by a company in consideration of
(a) acquiring any right with respect to the purchase of its own shares in pursuance of a contract approved under section 165, or
(b) the variation of a contract approved under section 164 or 165, or
(c) the release of any of the company's obligations with respect to the purchase any of its own shares under a contract approved under section 164 or 165 or under a contract for a purchase authorised under section 166,
must be made out of the company's distributable profits.

168(2) [Effect of not satisfying sec. 168(2) requirements] If the requirements of subsection (1) are not satisfied in relation to a contract-
(a) in a case within paragraph (a) of the subsection, no purchase by the company of its own shares in pursuance of that contracts is lawful under this Chapter,
(b) in a case within paragraph (b), no such purchase following the variation is lawful under this Chapter, and
(c) in a case within paragraph (c), the purported release is void.

SEC. 169 Disclosure by company of purchase of own shares

169(1) [Return to registrar] Within the period of 28 days beginning with the date on which any shares purchased by a company under with Chapter are delivered to it, the company shall deliver to the registrar of companies for registration a return in the prescribed form stating with respect to shares of each class purchased the number and nominal value of those shares and the date on which they were delivered to the company.

169(2) [Return for public company] In the case of public company, the return shall also state-
(a) the aggregate amount paid by the company for the shares; and
(b) the maximum and minimum prices paid in respect of shares of each class purchased.

169(3) [Inclusion in single return] Particulars of shares delivered to the company on different dates and under different contracts may be included in a single return to the registrar; and in such a case the amount required to be stated under subsection (2)(a) is the aggregate amount paid by the company for all the shares to which the return relates.

169(4) [Particular of authorised contracts to be kept at registered office] Where a company enters into a contract approved under section 164 or 165, or a contract for a purchase authorised under section 166, the company for all the shares to which the return relates.

169(5) [Sec. 169(4) particulars open for inspection] Every copy and memorandum so required to be kept shall, during business hours (subject to such reasonable restrictions as the company may in general meeting impose, provided that not less than 2 hours in each day are allowed for inspection) be open to inspection without charge-
(a) by any member of the company, and
(b) if it is a public company, by any other person.

169(6) [Penalty for non-delivery of return] If default is made in delivering to the registrar any return required by this section, every officer of the company who is in default is liable to a fine and, for continued contravention, to a daily default fine.

169(7) [Penalty for contravention of sec. 169(4), (5)] If default is made in complying with subsection (4), or if an inspection required under subsection (5) is refused, the company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine.

169(8) [Power of court to compel sec. 169(4) inspection] In the case of a refusal of an inspection required under subsection (5) of a copy or memorandum, the court may by order compel an immediate inspection of it.
169(9) [Application of sec. 169(40)] The obligation of a company under subsection (4) to keep a copy of any contract or (as the case may be) a memorandum of its terms applies to any variation of the contract so long as it applies to the contract.

SEC. **170 The capital redemption reserve**

170(1) [“Capital redemption reserve”] Where under this Chapter shares of a company are redeemed or purchased wholly out of the company’s profits, the amount by which the company’s issued share capital is diminished in accordance with section 160(4)on cancellation of the shares redeemed or purchased shall be transferred to a reserve, called “the capital redemption reserve”.
170(2) [Transfer to capital redemption reserve] If the shares are redeemed or purchased wholly or partly out of the proceeds of a fresh issue and the aggregate amount of those proceeds is less than the aggregate nominal value of the shares redeemed or purchased, the amount of the difference shall be transferred to the capital redemption reserve.
170(3) [Exception to application of sec. 170(2)] But subsection (2) does not apply if the proceeds of the fresh issue are applied by the company in making a redemption or purchase of its own shares in addition to a payment out of capital under section 171.
170(4) [Reduction of share capital provisions] The provisions of this Act relation to the reduction of a company’s share capital apply as if the capital redemption reserve were paid-up share capital of the company, except that the reserve may be applied by the company in paying up its unissued shares to be allotted to members of the company as fully paid bonus shares.

REDEMPTION OR PURCHASE OF OWN SHARES OUT OF CAPITAL
(PRIVATE COMPANIES ONLY)

SEC. **171 Power of private companies to redeem or purchase own shares out of capital**

171(1) [Source of payment] Subject to the following provisions of this Chapter, a private company limited by shares or limited by guarantee and having a share capital may, if so authorised by its articles, make a payment in respect of the redemption or purchase under section 160 or (as the case may be) section 162, of its own shares otherwise than out of its distributable profits or the proceeds of a fresh issue of shares.
171(2) [References to payment out of capital] References below in this Chapter to payment out of capital are (subject to subsection (6)) to any payment so made, whether or not it would be regarded apart from this section as a payment out of capital.
171(3) [Amount of payment] The payment which may (if authorised in accordance with the following provisions of this Chapter) be made by a company out of capital in respect of the redemption or purchase of its own shares is such an amount as, taken together with-
(a) any available profits of the company,and
(b) the proceeds of any fresh issue of shares made for the purposes of the redemption or purchase,

is equal to the price of redemption or purchase; and the payment permissible under this subsection is referred to below in this Chapter as the permissible capital payment for the shares.
171(4) [Transfer to capital redemption reserve] Subject to subsection (6), if the permissible capital payment for shares redeemed or purchased is less than their nominal amount, the amount of the difference shall be transferred to the company’s capital redemption reserve.

171(5) [Permissible capital payment exceeding nominal amount of shares] Subject to subsection (6), if the permissible capital payment is greater than the nominal amount of the shares redeemed or purchased-

(a) the amount of any capital redemption reserve, share premium account or fully paid share capital of the company, and

(b) any amount representing unrealised profits of the company for the time being standing to the credit of any reserve maintained by the company in accordance with paragraph 34 of Schedule 4 (revaluation reserve),

may be reduced by a sum not exceeding (or by sums not in the aggregate exceeding) the amount by which the permissible capital payment exceeds the nominal amount of the shares.

171(6) [Proceeds of fresh issue] Where the proceeds of a fresh issue are applied by a company in making any redemption or purchase of its own shares in addition to a payment out of capital under this section, the reference in subsections(4) and (5) to the permissible capital payment are to be read as referring to the aggregate that payment and those proceeds.

SEC. Availability of profits for purposes of sec. 171

172(1) [Reference to available profits of the company] The reference in section 171(3)(a) to available profits of the company is to the company's profits which are available for distribution (within the meaning of Part VIII); but the question whether a company has any profits so available and the amount of any such profits are to be determined for purposes of the section in accordance with the following subsections, instead of section 270 to 275 in that Part.

172(2) [Determination of amount of profits] Subject to the next subsection, that question is to be determined by reference to-

(a) profits, losses, assets and liabilities,

(b) provisions of any of the kinds mentioned in paragraphs 88 and 89 to Schedule 4 (depreciation, diminution in value of assets, retentions to meet liabilities, etc.), and

(c) share capital and reserves (including undistributable reserves),

as stated in the relevant accounts for determining the permissible capital payment for shares.

172(3) [The relevant accounts in sec, 172(2)] The relevant accounts for this purpose are such accounts, prepared as at any date within the period determining the amount of the permissible capital payment, as are necessary to enable a reasonable judgment to be made as to the amounts of any of the items mentioned in subsection (2)(a) to (c) above.

172(4) [Determination of amount of permissible capital payment] For purposes of determining the amount of the permissible payment for shares, the amount of the company's available profits (if any) determined in accordance with subsections (2) and (3) is treated as reduced by the amount of any distributions lawfully made by the company after the date of the relevant accounts and before the end of the period for determining the amount of that payment.

172(5) [Lawful distribution in sec. 172(4)] The reference in subsection (4) to distributions lawfully made by the company includes-

(a) financial assistance lawfully given out of distributable profits in a case falling within section 154 or 155,

(b) any payment lawfully made by the company in respect of the purchase by it of any shares in the company (except a payment lawfully made otherwise than out of distributable profits), and

(c) a payment of any description specified in section 168(1) lawfully made by the company.

172(6) [Period for determining the amount of permissible capital payment] References in this section to the period for determining the amount of the permissible capital payment for shares are to the period of 3 months ending with the date on which the statutory declaration of the directors purporting to specify the amount of that payment is made in accordance with subsection (3) of the section next following.

SEC. **173 Conditions for payment out of capital**

173(1) [Requirements for payment by private company] Subject to any order of the court under section 177, a payment out of capital by a private company for the redemption or purchase of its own shares is not lawful unless the requirements of this and the next two sections are satisfied.

173(2) [Approval by special resolution] The payment out of capital must be approved by a special resolution of the company.

173(3) [Statutory declaration by directors] The company's directors must make a statutory declaration specifying the amount of the permissible capital payment for the shares in question and stating that, having made full inquiry into the affairs and prospects of the company, they have formed the opinion-

(a) as regards its initial situation immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts, and

(b) as regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company during that year, the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year.

173(4) [Directors' opinion in sec. 173(3)(a)] In forming their opinion for purposes of subsection (3)(a), the directors shall take into account the same liabilities (including prospective and contingent liabilities) as would be relevant under section 517 (winding up by the court) to the question whether a company is unable to pay its debts.

173(5) [Form and content of statutory declaration, auditors' report] The directors' statutory declaration must be in the prescribed form and contain such information with respect to the nature of the company's business as may be prescribed, and must in addition have annexed to it a report addressed to the directors by the company's auditors stating that-

(a) they have inquired into the company's state of affairs; and

(b) the amount specified in the declaration as the permissible capital payment for the shares in question is in their view properly determined in accordance with sections 171 and 172; and

(c) they are not aware of anything to indicate that the opinion expressed by the directors in the declaration as to any of the matters mentioned in subsection (3) is unreasonable in all the circumstances.

173(6) [Penalty for unreasonable declaration] A director who makes a declaration under this section without having reasonable grounds for the opinion expressed in the declaration is liable to imprisonment or a fine, or both.

SEC. **174 Procedure for special resolution under sec. 173**

174(1) [Dates for special resolution and payment out of capital] The resolution required by section 173 must be passed on, or within the week immediately following, the date on which the directors make the statutory declaration required by that section; and the payment out of capital must be made no earlier than 5 nor more than 7 weeks after the date of the resolution.

174(2) [Limitation of approval by special resolution] The resolution is ineffective in any member of the company holdings shares to which the resolution relates exercises the voting rights carried by any of those shares in voting on the resolution and the resolution would not have been passed if he had not done so.

174(3) [Interpretation of sec. 174(2)] For purposes of subsection (2), a member who holds such shares is to be regarded as exercising the voting rights carried by them in voting on the resolution not only if he votes in respect of them on a poll on the question whether the resolution shall be passed, but also if he votes on the resolution otherwise than on a poll; and, not withstanding anything in a company's articles, any member of the company may demand a poll on that question.

174(4) [Inspection of statutory declaration and auditors' report] The resolution is ineffective unless the statutory declaration and auditors' report required by the section are available for inspection by members of the company at the meeting at which the resolution is passed.

174(5) [Vote and demand for poll be person as proxy] For purposes of this section a vote and a demand for a poll by a person as proxy for a member are the some (respectively) as a vote and demand by the member.

SEC. **175 Publicity for proposed payment out of capital**

175(1) [Notice in Gazette] Within the week immediately following the date of the resolution for payment out of capital the company must cause to be published in the Gazette a notice-

(a) stating that the company has approved a payment out of capital for the purpose of acquiring its own shares by redemption or purchase or both (as the case may be);

(b) specifying the amount of the permissible capital payment for the shares in question and the date of the resolution under section 173;

(c) stating that the statutory declaration of the directors and the auditors' report required by that section are available for inspection at the company's registered office; and

(d) stating that any creditor of the company may at any time within the 5 weeks immediately following the date of the resolution for payment out of capital apply to the court under section 176 for an order prohibiting the payment.

175(2) [Notice in appropriate national newspapers] Within the week immediately following the date of the resolution the company must also either cause a notice to the same effect as that required by subsection (1) to be published in an appropriate national newspaper or give notice in writing to that effect to each of its creditors.

175(3) ["An appropriate national newspaper"'] "An appropriate national newspaper" means a newspaper circulating throughout England and Wales (in the case of a company registered in England and Wales), and a newspaper circulating throughout Scotland (in the case of a company registered in Scotland).

175(4) [References to first notice date] References below in this section to the first notice date are to the day on which the company first publishes the notice required by subsection (1) or first publishes or gives the notice required by subsection (2) (whichever is the earlier).

175(5) [Statutory declaration and auditors' report to register] Not later than the first notice date the company must deliver to companies a copy of the statutory declaration of the directors and of the auditors' report required by section 173.

175(6) [Statutory declaration and auditors' report available for inspection] The statutory declaration and auditors' report-

(a) shall be kept at the company's registered office throughout the period beginning with the first notice date and ending 5 weeks after the date of the resolution for payment out of capital, and

(b) shall during business hours on any day during that period be open to the inspection of any member or creditor of the company without charge.

175(7) [Penalty on refusal of sec. 175(6) inspection] If an inspection required under subsection (6) is refused, the company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine.

175(8) [Power of court to compel inspection] In the case of refusal of an inspection required under subsection (6) of a declaration or report, the court may by order compel an immediate inspection of the declaration or report.

SEC. **176 Objections by company's members or creditors**

176(1) [Application for cancellation] Where a private company passes a special resolution approving for purposes of this Chapter any payment out of capital for the redemption or purchase of any of its shares-

(a) any member of the company other than one who consented to or voted in favour off the resolution; and

(b) any creditor of the company,

may within 5 weeks of the date on which the resolution was passed apply to the court for cancellation of the resolution.

176(2) [Maker of application] The application may be made on behalf of the persons entitled to make it by such one or more of their number as they may appoint in writing for the purpose.

176(3) [Obligations of company] If an application is made, the company shall-

(a) forthwith give notice in the prescribed form of that fact to the registrar of companies; and

(b) within 15 days from the making of any order of the court on the hearing of the application, or such longer period as the court may by order direct, deliver an office copy of the order to the registrar.

176(4) [Penalty] A company which fails to comply with subsection (3), and any officer of it who is in default, is liable to a fine and for continued contravention, to a daily default fine.

SEC. **177 Powers of court on application under sec. 176**

177(1) [Adjournment, directions and orders by court] On the hearing of an application under section 176 the court may, if it thinks fit, adjourn the proceedings in order that an arrangement may be made to the court's satisfaction for the purchase of the interests of dissentient members or for the protection of dissentient creditors (as the case may be); and the court may give such directions and make such orders as it thinks expedient for facilitating or carrying into effect any such arrangement.

177(2) [Terms of court order etc.] Without prejudice to its powers under subsection (1), the court shall make an order on such terms and conditions as it thinks fit either confirming or cancelling the resolution; and, if the court confirms the resolution, it may in particular by order alter or extend any date or period of time specified in the resolution or in any provision in this Chapter which applies to the redemption or purchase of shares to which the resolution refers.

177(3) [Further scope of court order] The court's order may, if the court thinks fit, provide for the purchase by the company of the shares of any of its members and for the reduction accordingly of the company's memorandum and articles as may be required in consequence of that provision.
177(4) [Where order requires no alteration in memorandum or articles] If the court's order requires the company not to make any, or any specified, alteration in its memorandum or articles, the company has not then power without leave of the court to make any such alteration in breach of the requirement.
177(5) [Effect of sec. 177(4) alteration] An alteration in the memorandum or articles made by virtue of an order under this section, if not made by resolution of the company, is of the same effect as if duly made by resolution; and this Act applies accordingly to the memorandum or articles as so altered.

SUPPLEMENTARY

SEC. **178 Effect of company's failure to redeem or purchase**

178(1) [Effect] This section has effect where a company has, no or after 15th June 1982,-
(a) issued shares in terms that they are or are liable to be redeemed, or
(b) agreed to purchase any of its own shares.
178(2) [Company not liable in damages] The company is not liable in damages in respect of any failure on its part to redeem or purchase any of the shares.
178(3) [Qualification to sec. 178(2)] Subsection (2) is without prejudice to any right of the holder of the shares other than his right to sue the company for damages in respect of its failure; but the court shall not grant an order for specific performance of the terms of redemption or purchase if the company shows that it is unable to meet the costs of redeeming or purchasing the shares in question out of distributable profits.
178(4) [Enforcement of terms of redemption or purchase] If the company is wound up and at the commencement of the winding up any of the shares have not been redeemed or purchased, the terms of redemption or purchase may be enforced against the company; and when shares are redeemed or purchased under this subsection, they are treated as cancelled.
178(5) [Non-application of sec. 178(4)] However, subsection (4) does not apply if-
(a) the terms provided for the redemption or purchase to take place at a date later than that of the commencement of the winding up, or
(b) during the period beginning with the date on which the redemption or purchase was to have taken place and ending with the commencement of the winding up the company could not at any time have lawfully made a distribution equal in value to the price at which the shares were to have been redeemed or purchased.
178(6) [Priority payments] There shall be paid in priority to any amount which the company is liable under subsection (4) to pay in respect of any shares-
(a) all other debts and liabilities of the company (other than any due to members in their character as such),
(b) if other shares carry rights (whether as to capital or as to income) which are preferred to the rights as to capital attaching to the first-mentioned shares, any amount due in satisfaction of those preferred rights;
but, subject to that, any such amount shall be paid in priority to any amounts due to members in satisfaction of their rights (whether as to capital or income) as members.
178(7) [Liability to pay interest] Where by virtue of section 66 of the Bankruptcy Act 1914 (payment of interest on debts) as applied by section 612 (application of bankruptcy rules to insolvent companies in England and Wales) a creditor of a company is entitled to payment of any interest only after payment of all other debts of the company, the company's debts and liabilities for purposes of sub-section (6) of this section include the liability to pay that interest.

SEC. **179 Power for Secretary of State to modify this Chapter**

179(1) [Regulations modifying provisions of Ch. VII] The Secretary of State may by regulations made by statutory instrument modify the provisions of this Chapter with respect to any of the following matters-

(a) the authority required for a purchase by a company of its own shares,
(b) the authority required for the release by a company or its rights under a contract for the purchase of its own shares or a contract under which the company may (subject to any conditions) become entitles or obliged to purchase its own shares,
(c) the information to be including a return delivered by a company to the registrar of companies in accordance with section 169(1),
(d) the matters to be dealt with in the statutory declaration of the directions under section 173 with a view to indicating their opinion of their company's ability to make a proposed payment out of capital with due regard to its financial situation and prospects, and
(e) the contents of the auditors' report required by the section to be annexed to that declaration.

179(2) [Further regulations] The Secretary of State may also be regulations so made make such provision (including modification of the provisions of this Chapter) as appears to him to be appropriate-

(a) for wholly or partly relieving companies from the requirement of section 171(3)(a) that any available profits must be taken into account in determining the amount of the permissible capital payment for shares under that section, or
(b) for permitting a company's share premium account to be applied, to any extent appearing to the Secretary of State to be appropriate, in providing for the premiums payable on the redemption or purchase by the company of any of its own shares.

179(3) [Content of regulations] Regulations under this section-

(a) may make such further modification of any provisions of this Chapter as appears to the Secretary of State to be reasonably necessary in consequence of any provision made under such regulations by virtue of subsection (1) or (2),
(b) may make different provision for different cases or classes of case, and
(c) may contain such further consequential provisions, and such incidental and supplementary provisions, as the Secretary of State thinks fit.

179(4) [Approval of regulations] No regulations shall be made under this section unless a draft of the instrument containing them has been laid before Parliament and approved by resolution of each House.

SEC. **504 Liability of past directors and shareholders**

504(1) [Application] This section applies where a company is being wound up and-

(a) it has under Chapter VII of Part V made a payment out of capital in respect of the redemption or purchase of any of its own shares (the payment being referred to below as "the relevant payment"), and

(b) the aggregate amount of the company's assets and the amounts paid by way of contribution to its assets (apart from this section) is not sufficient for payment of its debts and liabilities and the costs, charges and expenses of the winding up.

504(2) [Contribution of past shareholders and directors] If the winding up commenced within one year of the date on which the relevant payment was made then-

(a) the person from whom the shares were redeemed or purchased, and

(b) the direction who signed the statutory declaration made in accordance with section 173(3) for purposes of the redemption or purchase (except a director who shows that he had reasonable grounds for forming the opinion set out in the declaration),

are, so as to enable that insufficiency to be met, liable to contribute to the following extent to the company's assets.

504(3) [Amount payable] A person from whom any of the shares were redeemed or purchased is liable to contribute an amount not exceeding so much of the relevant payment as was made by the company in respect of his shares and the directors are jointly and severally liable with that person to contribute that amount.

504(4) [Application to court] A person who has contributed any amount tot he assets in pursuance of this section may apply to the court for an order directing any other person jointly and severally liable in respect of that amount to pay him such amount as the court thinks just and equitable.

504(5) [Non-application of sec. 502, 503] Sections 502 and 503 above do not apply in relation to liability accruing by virtue of this section.

504(6) [Regulations under sec. 179] This section is deemed including in Chapter VII of Part V for the purposes of the Secretary of State's power to make regulations under section 179.

APPENDIX 2

AUSTRALIAN ASSOCIATED STOCK EXCHANGES: DISCUSSION PAPER (1986) SUMMARY OF RECOMMENDATIONS [Cross Referenced to relevant paragraphs of the CSLRC Discussion Paper]

The AASE, having examined the issue of whether Australian companies should be allowed to purchase their own shares, recommends that Australian company law be amended to permit companies to purchase their own shares, subject to the following safeguards:

(1) companies purchasing their own shares must do so out of undistributed profits: see [5025]-[5033],

(2) when a company has purchased its own shares, the shares shall be cancelled and treated as authorized but unissued capital: see [50731-[5079],

(3) a listed company shall not purchase its own shares unless authorized initially by its members to do so at a general meeting of the company. After the initial authorization by shareholders a listed company may purchase:

(i) up to 10% of its shares on issue during any period of 12 months without further reference to shareholders,

(ii) up to an additional 10% of its shares in any period of 12 months provided shareholders have specifically authorized the purchase in excess of the first 10%. This specific authorization is to expire 12 months after it is given, and

(iii) any number of shares by way of a tender to all shareholders: see [5008]-[5014];[5043]-[5044]; [5055]-[5058],

(4) for reasons of flexibility, these percentage limit safeguards should be prescribed by stock exchange listing rules rather than by statute or statutory regulations: [no cross-reference],

(5) listed companies should be required to purchase their own shares in the ordinary course of business at an Official Meeting of a stock market of a stock exchange unless:

(i) the offer to purchase is by way of tender to all shareholders,

(ii) the offer is to purchase odd lots, or

(iii) the offer is to purchase shares to which employees are entitled and those shares were issued to employees in accordance with an employees share ownership scheme: see [5042]-[5050],

(6) in the case of an unlisted company each proposed purchase by a company of its own shares shall have the prior approval of its shareholders. At a meeting of shareholders to approve the contracts of sale no voting rights shall be permitted to the registered holder(s) of the shares to be purchased by the company: see [5008]-[5014],

(7) when a company buys its own shares it should be an implied condition, and recorded in the company's minutes, that the directors are of the opinion that the purchase will not affect the company's ability to pay its debts as they fall due. The directors should be made liable if this opinion is later proven either dishonest or negligent in its determination: see [50341-5041]; [5095]-[5096]; [5100]-[5104],

(8) the laws relating to insider trading shall apply to a company purchasing its own shares: see [411]-[414],

(9) companies must disclose to the NCSC, and in the case of a listed company to the stock exchanges, details of purchases of their own shares within one month of the

purchase date. The details to be disclosed are the number of shares purchased, the aggregate amount paid for the shares, the minimum and maximum prices paid per share and the issued capital of the company after the purchase: see [5070]-[5071],

(10) a company which purchases its own shares during a financial year shall disclose details of the purchases in its annual report as a note to its accounts or group accounts, as the case may be: see [5072],

(11) companies shall not purchase their own partly paid shares: see 150511, and

(12) a company shall maintain a register of all contracts for the purchase of its own shares and keep them available for inspection by shareholders: see [5072].