mcmahon clarke

FACT SHEET

Share capital transactions—the basics

This factsheet outlines the basic details of share capital transactions.

WHAT IS SHARE CAPITAL?

Companies issue shares to investors to raise funds for operating their business activities. Share capital is the total amount of money or other property investors provide to a company in consideration for the shares issued to them. However, this money is not a fund which is preserved within the company for the protection of creditors and ultimately shareholders.

MAINTAINING SHARE CAPITAL

A company is required to maintain its issued share capital. A company's creditors can only look to the issued capital, and the way it has been applied, for payment in the event of a winding up. Similarly, company shareholders are entitled to expect the issued capital will be employed by the company for the purposes set out in the company's constitution or as promised to shareholders at the time capital was raised.

A company is generally prohibited from reducing its issued share capital because this would prejudice the rights of creditors. The reduction would in effect diminish the pool of funds available to the company to pay its creditors.

Given the objectives behind the maintenance of share capital doctrine, the rules apply to almost all companies, not just public or listed corporations.

PERMITTED SHARE CAPITAL REDUCTIONS

The strict application of the capital maintenance regime has been modified over time and the Corporations Act allows a company to reduce its share capital if the reduction—

- is fair and reasonable to the shareholders as a whole
- does not materially prejudice the company's ability to pay its creditors, and
- is approved by shareholders.

Examples of share capital reductions include cancelling uncalled capital owing by shareholders or buying back issued shares which are then cancelled.

TYPES OF REDUCTION

A reduction of capital is either an equal reduction or a selective reduction.

An equal reduction must meet these conditions:

- It relates only to ordinary shares.
- It applies to each holder of ordinary shares in proportion to the number of shares they hold.
- The terms of the reduction are the same for each shareholder.

If any of these three conditions do not apply, then the reduction is selective.

SHAREHOLDER APPROVAL

Both forms of capital reduction require shareholder approval.

An equal reduction only requires approval by way of ordinary resolution (unless the company's constitution requires a special resolution).

A selective reduction must be approved by either—

- a special resolution (with certain voting restrictions), or
- a resolution agreed to by all ordinary shareholders.

KEEPING ASIC INFORMED

In both cases, ASIC must be notified of the reduction in share capital before the shareholder meetings are called. Once the capital reduction has taken place, ASIC must be notified of changes to the company's share structure. In the case of a selective reduction, ASIC must also be given a copy of the passed resolution.

SHARE BUY BACKS

Share buy backs are one example of capital reductions. A company may buy back its own shares if the buy back does not materially prejudice the company's ability to pay its creditors and the procedures laid down in the Corporations Act are followed.

There are five types of buy backs:

- **Equal access schemes**—offers made to all ordinary shareholders on the same terms.
- **Selective buy backs**—offers made to particular shareholders only.
- **On market buy backs**—a listed company buys back its shares in the ordinary course of trading.
- **Minimum holding buy backs**—a listed company buys small parcels of shares which are not marketable parcels on the exchange.
- **Employee share scheme buy backs**—a company buys shares held by, or for the benefit of, employees under an existing employee share acquisition scheme approved by the company in a general meeting.

Some equal access scheme buy backs require shareholder approval by ordinary resolution. All selective buy backs require a special resolution or a resolution agreed to by all ordinary shareholders.

As with share capital reductions, documents must be lodged with ASIC at the beginning and end of the process.

Once a company has entered an agreement to buy back shares, all rights attaching to the shares are suspended and the shares must be cancelled once they are bought back.

SOLVENCY

Directors of a company must ensure a buy back does not cause the company to become insolvent.

DIVIDENDS

Previously, dividends could only be paid to shareholders out of company profits. Payment to shareholders other than out of profits would therefore have been a reduction in share capital. The Corporations Act now has a more flexible requirement that allows a company to pay dividends if—

- the company's assets exceed its liabilities and the excess is sufficient for the payment of a dividend
- it is fair and reasonable to the company's shareholders as a whole, and
- it does not materially prejudice the company's ability to pay its creditors.

Significantly however, the Corporations Act does not permit a company to pay a dividend that amounts to a reduction of share capital.

HOW CAN WE HELP?

Our lawyers understand the complexities of share capital transactions. Please contact us for assistance or more information.

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