Chapter 8 – Capital and capital maintenance

Milo Ltd was incorporated in November 2010 and has issued 5,000 shares, all with a nominal value of £1 each. The company’s two directors, Ceri and Ross, each own 1,000 shares. Theo, a local businessman, owns 2,000 shares and the remaining 1,000 shares are owned by a number of local investors.

Since it was incorporated, the company has run at a loss and has never made a profit. Theo believes that this is due to Ceri and Ross’s poor management of the company. He also believes that, with new management, the company could be extremely profitable. He therefore starts buying from the local investors the shares that they hold in Milo Ltd with a view to voting Ceri and Ross out of office.

Ceri and Ross discover Theo’s plan. Accordingly, they cause the company to issue 3,000 new shares and offer to sell them to their friend, Gabrielle. However, Gabrielle cannot afford to buy these shares, but she does offer to sell her car to Milo Ltd as part-payment for the shares. The car is only worth £1,500 but Ceri and Ross accept the car as part-payment providing that Gabrielle uses the voting rights attached to her shares to defeat any resolution that aims to remove Ceri and Ross from office. The remaining payment comes in the form of £500, which Gabrielle loans from Milo Ltd.

Theo, realising that his scheme to oust Ceri and Ross has failed wishes to sell his shares, but he cannot find a buyer. Ceri tells Theo the Milo Ltd will purchase the shares. By now, Theo has 2,500 shares and he agrees to sell them to Milo Ltd. The company purchases the shares and they are duly cancelled. Having rid themselves of the troublesome Theo, Ceri and Ross recommend that a dividend be paid at a rate of 10 pence per share. Gabrielle agrees and between them, the dividend is declared and paid out.

Discuss the validity of Ceri and Ross’s actions.

Introduction

- This seemingly straightforward question raises a surprising number of issues. Point out that as Milo is a private company, it will subject to less regulation in this area than public companies.

Issuing of shares

- The first issue to discuss is Ceri and Ross causing the company to issue new shares to Gabrielle. This raises two important issues that you will need to discuss:
1. The shares have been issued directly to Gabrielle, which will cause the shareholdings of the other shareholders to be diluted. Indeed, this appears to be the purpose of the issue. To prevent this, existing shareholders are given pre-emption rights whereby a new issue of shares must first be offered to them. As the shares have been issued to an outsider without first being offered to the existing shareholders, it would appear there has been a breach of the shareholders’ pre-emption rights. The result will be that the allotment of shares is still valid, but Milo Ltd and Ceri and Ross will be liable to compensate the shareholders who would have benefitted from the pre-emptive offer.

2. The CA 2006, s 171 places a duty on directors to exercise their powers only for the purposes for which they are conferred. You should note that differing company law topics can often interact in this way and you should not assume that a problem will address a single topic only. The courts’ approach is to determine the dominant purpose of the exercise of power (Howard Smith Ltd v Ampol Petroleum Ltd [1974]), and there is little doubt that the dominant purpose of the allotment is to reduce Theo’s shareholding and prevent him from obtaining the shares needed to vote Ceri and Ross out of office. This will almost certainly breach the s 171 duty. Where directors act for an improper purpose, such acts are voidable at the company’s discretion and the directors in question may be required to compensate the company for any loss sustained.

Payment of shares

- The second issue to discuss is Gabrielle’s payment for the shares. Shares can be purchased in ‘money or money’s worth’ so the fact she has part-paid by selling her car is not a problem. The remaining money comes in the form of a £500 loan that Milo Ltd makes to Gabrielle. Again, two issues should be discussed:
  1. As £3,000 worth of shares have been issued and the total payment received by the company has been £2,000, it would appear the shares have been issued at a discount. This is prohibited by the CA 2006, s 580. The allottee (Gabrielle) will be liable to compensate Milo for the amount of the discount plus interest. Milo Ltd and Ceri and Ross will also have committed a criminal offence.
  2. Milo Ltd has provided Gabrielle with financial assistance for the share purchase. Under the CA 2006, such assistance was generally prohibited. However, the CA 2006 has abolished this prohibition in relation to private companies, so the £500 loan cannot be questioned on this ground.

Purchasing of shares

- The third issue to discuss relates to Milo Ltd purchasing Theo’s shares. The CA 2006, s 658 provides that companies cannot purchase their own shares, except in accordance with the procedures laid down in the CA 2006, so you will need to discuss whether these procedures have been followed. Notably, the Act requires the payment of shares to come out of distributable profits and, as Milo Ltd has never made a profit, it would appear that the Act has not been complied with.
Payment of the dividend

- The fourth and final issue involves the payment of the dividend. You will want to discuss whether or not the payment of the dividend has complied with the requirements set out in the Act. Notably, the **CA 2006, s 830** provides that companies cannot pay dividends out of capital and, as Milo Ltd has no distributable profits, it appears that it has paid a dividend out of capital. Ceri and Ross will be liable to pay the money distributed back to Milo Ltd, providing they knew, or ought to have known, that the distribution was unlawful. Any shareholder will also be liable to repay the money if, at the time of the distribution, they knew or had reasonable grounds to believe that the distribution was unlawful.