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REDUCTION OF SHARE CAPITAL: A FRAGILE FOUNDATION FOR THE LAW OF REPURCHASE, FORFEITURE AND SURRENDER OF SHARES

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Introduction

There is pretty little in our Companies Acts enacted in over a hundred years regulating forfeiture, surrender, redemption and reacquisition of shares. Forfeiture of shares for nonpayment of duly made calls in respect of them is provided for by Table A of the First Schedule[1] which applies to all companies limited by shares in so far as they are not excluded or modified by the company's own articles. The only other reference to forfeiture is in section 75(5) of the Companies Act, 1956 which provides that no return as to allotment need be filed with the Registrar by a company in respect of the issue and allotment by it of shares which under the provisions of its articles were forfeited for nonpayment of calls. The word "surrender" does not appear anywhere in the statute. The only reference to redemption of shares is in section 80 of the Act which provides for the redemption of redeemable preference shares. It may be remembered that it was the English Companies Act of 1929 which for the first time permitted companies to issue redeemable preference shares. Section 77 of the Act enjoins that "No company limited by shares, and no company limited by guarantee and having a share capital, shall have power to buy its own shares, unless the consequent reduction of capital is effected and sanctioned in pursuance of "the provisions of the Act.

The law of forfeiture, surrender and repurchase of shares has been of judicial origin and in this task the courts have mainly relied upon the provisions in the company statutes for the reduction of share capital.

Reduction of Share Capital

Provisions for the "Reduction of Capital and Shares" were first introduced in England by the amending Act of 1867. The Act of 1862 contained none for the purpose, though it did for increasing the capital by the issue of new shares, for consolidating and dividing the shares into shares of a larger par value, etc.

The language of the reduction provision of the Act of 1867 is so significantly different from its twentieth century version first adopted in the Act of 1906 that it must be quoted:

> Reduction of Capital and Shares.
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> 9. Any Company limited by Shares may, by special Resolution, so far modify the Conditions contained in its Memorandum of Association, if authorised to do so by its Regulations as originally framed or as altered by special Resolution, as to reduce its Capital; but no such Resolution for reducing the Capital of any Company shall come into operation until an Order of the Court is registered by the Registrar of Joint Stock Companies, as hereinafter mentioned.
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> Power of Company to reduce Capital

It may be seen that the section speaks of reduction of "capital" and not "share capital" as the twentieth century version does.[2] It speaks of modification of the conditions contained in the memorandum as if it applied only to cases of alteration of the authorised or nominal capital.[3] The twentieth century version has abandoned that language. But the safeguards provided by the Act of 1867 have been substantially preserved by the English Acts until the present day.

Section 9 of the English Act of 1867 remained in the statute book until 1908 and most of the leading English decisions on the law of corporation finance were founded on it. When one wades through the quagmire of these English decisions, one is persuaded that the section was ill-drafted.

For example, doubts persisted whether the Act of 1867 authorised the reduction of paid-up capital which had already been lost. In 1877 Jessel, M.R., held in In re Ebbw Vale Steel, Iron and Coal Co.[4] that it did not. According to the Master of the Rolls the section applied when a company sought to reduce its capital by returning its assets to its shareholders or by extinguishing or diminishing their liability in respect of unpaid capital, but not where a reduction of "capital" had already occurred otherwise and a company was seeking to write it off. Parliament acted immediately to amend the Act of 1867 to bring within the scope of the reduction provisions situations as in Ebbw.

In Ebbw the company's assets which consisted of coal and iron mines had become depreciated in value due to the "great fall which had then taken place in the value of iron and coal" and the company sought to write off the depreciation to the paid-up share capital account. Jessel, M.R., failed to appreciate that the crucial question in such cases is whether the company should be permitted to charge the diminution in the value of its fixed assets to the issued share capital account or required to charge it to any existing or future earned or other surplus. The amending Act of 1867 only clarified that the court could permit a company to charge such depreciation, diminution or loss to the issued share capital account, but gave the court no guidance for the exercise of its discretion.

Though the Act of 1877 authorised the courts to permit companies to write off any loss or diminution to the paid-up share capital, the courts have made any such step unimportant. Until Lee v. Neuchatel Asphalte Co.[5] decided in 1889 it was generally believed that no divident could lawfully be paid unless and until lost capital had been replaced or the capital reduced as provided by the Act. But that decision and Verner v. General and Commercial Investment Trust[6] made it clear that "a trading profit may be applied in payment of dividends notwithstanding a depreciation in the fixed capital of the company." The outcome of this development is that in practice a company can continue to pay dividends out of its current profits despite unwritten off past losses, whether on the capital or revenue account, and the company need not even bother itself to take steps to reduce its share capital to the extent of such losses.

It seems to the writer that in all these cases the courts were using the expression "capital" in the sense of economical capital and not legal or share capital and in contradistinction to income or profit. Any reduction in the economic capital otherwise than in the ordinary course of carrying on the business of the company needs judicial approval. The capital can be used only for the purpose of carrying on the authorised business of the company. The capital cannot be used by a company for repurchasing its shares without judicial sanction. Dividends cannot be paid out of the capital, but only out of the earnings or income. Where part of the capital has become lost, the earnings produced by the remaining capital does not represent the lost capital and need not be applied in making good the lost capital. Many of the English cases can be explained if reduction of capital is understood to mean the reduction of the trading or economic capital. But the Act of 1908 changed the language of the reduction provisions to make it clear that what the sections contemplated was reduction of share capital or what the Americans call "legal capital". After this change it is indeed difficult to support the authorities like Trevor v. Whitworth in situations where there is no reduction of share capital, though there is a reduction of the trading capital.

Share capital is an arbitrary legal concept devoid of economic significance. Reduction of share capital means a debit or charge to the issued share capital and this attracts the requirement of judicial confirmation under the present Companies Acts. The law would have greatly conduced to clarity if, instead of omnibus provisions for reduction of share capital, it had dealt with the specific situations which involve a reduction of issued share capital and given us a clear answer to the following questions: (i) Can a company waive, wholly or in part, its claim to unpaid subscriptions due by its shareholders and thus reduce its issued share capital? If so, subject to what conditions and restrictions? (ii) Can a company distribute any part of its assets to its shareholders in partial liquidation and charge such payments to its issued share capital? If so, subject to what conditions and restrictions? (iii) Under what circumstances, if any, can a company write off a loss or diminution in the value of its assets by charging it to the issued share capital?

(iv) When is a company free or not free to by-pass its earned surplus or capital surplus accounts and make a debit directly to its issued share capital account? (v) Can a company reduce its issued share capital in order to covert thereby a part of it into surplus-the "reduction surplus" as it is sometimes called? Much of the confusion that surround the law of corporation finance in general, and the law of dividend in particular, is attributable to the failure to face these questions beyond laying down the omnibus provisions for reduction of share capital or share capital.

While it is true that the Companies Acts have adequately protected the rights of creditors in reduction cases by giving them virtually a power of veto, it should be remembered that reduction of share capital involves considerable difficulties in adjusting the interests of shareholders inter se and it is therefore not surprising that many a reduction of share capital has met with opposition from shareholders rather than from creditors. But the courts have tended to regard the technique of reduction to be a matter of domestic concern for the company to determine for itself and refrained from interfering unless it is shown to be unfair or inequitable. It is no exaggeration to say that this approach of the courts has generally operated unfairly to minority and preference shareholders.

In short, the omnibus reduction provisions have only served to conceal the real issues involved in these cases and the policy determinations that are called for. Their application to forfeitures, surrenders and repurchases has had the same consequence as we shall see in the following pages.

2. Repurchase of Shares

English decisions holding that companies cannot repurchase their issued shares proceed on the following reasoning. First, it is repugnant to the provisions of the Companies Act of 1862 that a company should be a member of itself. Secondly, the repurchase inevitably reduces capital and is therefore impermissible except when confirmed by the court as provided by the statute.[7] Thirdly, repurchase and reissue of shares amount to unlawful trafficking in shares.

The view that a company cannot be a member of itself has been justified on the grounds that it cannot be made a debtor to itself for calls or made a contributory in its own liquidation, both of which assume that the shares concerned are partly paid-up. The argument completely fails if the shares are fully paid-up and the law would allow a company to be the holder of its fully paid-up shares. Nor can there be any insurmountable obstacle to denying the company voting and other rights of membership in respect of such shares so long as they remain in its treasury.

The objection that a repurchase and reissue of shares would be an unlawful trafficking in the shares appears to be based on the doctrine of ultra vires and can be overcome if the statute or memorandum confers powers on the company to do so.

Though every repurchase involves expenditure by the company of its moneys or assets, there need be no reduction of "share capital" or even "capital", if the repurchase is made by the company out of its current earnings or earned surplus or other free surplus. In all the cases which came before the English courts, the companies were financially embarrassed ones and none was seeking to repurchase its shares, with powers conferred by its memorandum, out of funds which it had ready and available for the payment of dividends. So none of them can be regarded as authority for the proposition that a company cannot repurchase its issued fully paid-up shares out of current income or accumulated profits or other free surpluses. Even if we assume that the English authorities proceed on a larger hypothesis that the trading capital cannot be expended by a company in the purchase of its shares, such hypothesis cannot now be supported by reference to the twentieth century version of the reduction of share capital provisions.

Eversince the Act of 1908 it is beyond doubt that only a reduction of issued share capital needs judicial confirmation.

It was not until the English Companies Act of 1948 that share-premium amounts, i.e. paid-in surpluses, were brought within the ambit of these provisions. Section 77 of our Companies Act forbids a limited

company with share capital to buy its own shares "unless the consequent reduction of capital is effected and sanctioned in pursuance of sections 100 to 104...." Though the section speaks of "capital", it can only mean share capital as sections 100 to 104 deal only with reduction of share capital. It follows that if a repurchase does not involve a reduction of share capital, the prohibition in section 77 will not apply.

In 1929 the English Act authorised the issue of redeemable preference shares and their redemption, provided they are fully paid-up, out of the profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purpose of the redemption. Where such shares are redeemed otherwise than out of the proceeds of a fresh issue of shares, the company must transfer out of its profits to a reserve fund, to be called "the capital redemption reserve fund", an amount equal to the aggregate par value of the shares redeemed. The premium, if any, payable on redemption must also have been provided for out of the profits or share premium accout of the company. In short, upon the redemption of redeemable preference shares, the issued share capital will be reduced by charging the total par value of the redeemed shares to that account, the premia charged to the profits or the share premium accout, and an amount equal to the reduction in share capital transferred out of the profits to the so-called "capital redemption reserve fund". This fund created by freezing the profits may be capitalised by the issue of a share-dividend, but may not otherwise be reduced except by the procedure for the reduction of paid-up share capital. Perhaps this provision could have been made less cumbersome by requiring that redeembale preference shares can be redeemed only out of the profits of the company (except where they are redeemed out of the proceeds of a special issue of shares made for the purpose) and that no such redemption shall reduce the issued share capital.

It is difficult to see why the law should not permit companies to buy their common or equity shares as well as their preference shares, whether issued as redeemable or not, provided that the repurchase is made only out of the profits of the company available

for the payment of dividend and the issued share capital is not there by impaired. Indeed in such a case a company may even be permitted to buy its partly paid shares, provided that it would freeze its distributable surplus to the extent of the full par value of the reacquired shares. The frozen surplus may be released and rendered distributable to the extent that the reacquired fully paid-up or partly paid shares are reissued.

Companies can usefully exercise the power to repurchase their issued shares in a variety of circumstances without having to approach the court for confirmation everytime. Thus a company can use its earned surplus to purchasing the shares of a member who wishes to retire and this will be a great help to the member where the shares do not have an open market. A company may purchase its shares out of its profits and distribute them among its employees as incentive bonuses. Section 77 itself permits companies to provide moneys, in accordance with any scheme for the time being in force, "for the purchase of, or subscription for, fully paid shares in the company or its holding company, being a purchase or subscription by trustees of or for shares to be held by or for the benefit of employees of the company, including any director holding a salaried office or employment in the company." A company may amicably buy even systematically repurchase all its issued shares in which case the law may require that the management should thereafter be chosen by and accountable to the workers-a method of socialisation by the backdoor!

Of course repurchase by a company of its issued shares and reissue of these shares raise a host of issues which will have to be examined and appraised, as American experience shows, and institutions and devices will have to be worked out to check abuse of the power. But the total ban of repurchases founded on the reasoning of Trevor v. Whitworth is, it is submitted, both misconceived and purposeless and has only served to arrest and distroy the evolution of the law of corporation finance in this area.

3. Forfeiture of Shares

Forfeiture means the loss of property as a penalty for some act or omission and differs from expropriation which means compulsorily depriving a person of a right of property belonging to him in return for compensation. It is trite learning that forfeitures are disfavoured by the law, hence strictly construed and equitable reliefs afforded against it.

As observed earlier, Table A provides for forfeiture of shares for nonpayment of calls for instalments of calls and section 75(5) provides that upon the reissue of shares forfeited for nonpayment of calls, no return as to the allotment need be filed with the Registrar under that section.

The law in England and the British Commonwealth countries is that the authority of a company to forfeit shares extends to only cases where calls are owing in respect of the very shares and that an article purporting to give power to forfeit for any other reasons is void. Therefore fully paid-up shares can in no case be forfeited and shares cannot be forfeited because any money other than for calls in respect of them is owing. This is an eminently sensible rule. Companies are permitted to forfeit shares as an efficient method for enforcing payment of calls in respect of them, but denied a general power to forfeit shares. This salutary rule, which conforms to the norms of equity, was laid down in Hopkinson v. Mortimer, Harley & Co., Ltd.,[8] but unfortunately and unnecessarily justice Eve rested his decision on the ground that every forfeiture of shares even if fully paid-up, amounted to a reduction of capital and that forfeiture of shares for nonpayment of calls is an exceptional case allowed by the legislature.

It is indeed difficult to agree with Justice Eve that the forfeiture of fully paid-up shares amounts to a reduction of capital, unless we regard the forfeited share to be no longer an issued share and therefore the issued share capital reduced accordingly. But the decision that he reached, viz. to deny companies a general power to forfeit shares, is sound and salutary. But the Calcutta High Court has rejected

the salutary rule on the ground that it is supported on an unsound premise and reached the conclusion in a series of cases that companies can assume by their articles of association a general power to forfeit shares.[9] The Supreme Court of India did not avail itself of a recent opportunity to review the Calcutta cases.[10] The result is that according to the Calcutta High Court companies in India can assume by their articles a general power to deprive their shareholders of their shares (which is becoming increasingly the most important item of property today) without payment of compensation-a power not possessed even by sovereign governments in civilized countries except in very rare instances. The Calcutta High Court has even held that it would be *ultra vires* of a company in such cases to pay the shareholder the surplus sale proceeds of the forfeited share after recovering the money owed it by the shareholder![11] It is submitted that the recognition of a general power of forfeiture is misconceived and is an unfortunate result of attempting to found the law of forfeiture on the statutory provisions for the reduction of capital. Forfeiture is a penal deprivation of property without compensation. Trading companies do not need a general power to forfeit shares as they can adequately protect themselves by a lien on the shares where moneys are owed to the company by a shareholder. Recognition of a general power of forfeiture is indeed fraught with dangerous potentialities.

4. Surrender of Shares

A surrender is a voluntary relinquishment of property rights. The word "surrender" appears nowhere in our Companies Acts. While a forfeiture is a penal, coercive and deprivatory measure initiated by a company, a surrender in its proper sense is a voluntary abandonment of property initiated by the shareholder. They are two separate concepts for quite different ends, but the courts have attempted to regulate them both by the same test of reduction of capital. The law of surrender has a result become needlessly confused and chaotic.

It is clear that a company may accept a surrender of shares under circumstances in which it could have validly forfeited the shares, i.e. as a short-cut to forfeiture. It is equally clear that a pretended or collusive forfeiture in order to facilitate a member to surrender his shares and escape his liability thereon is illegal, if the company cannot validly accept a surrender in the circumstances of the case. Beyond these propositions, the law is quite unclear.

One would have supposed that there could be no objection to a company accepting a surrender of fully paid-up shares, provided that the issued share capital remains unaffected. The issued shares thus surrendered can be treated as treasury shares and the issued share capital can remain intact as before. But unfortunately the question whether a company can accept a surrender of fully paid-up shares is still unsettled. Though it appears that the courts would in some instances uphold such surrenders,[12] the precise limits of a company's authority to accept surrenders of fully paid-up shares are yet to be determined.

So long as a company is not parting with any of its assets, whether directly or indirectly, or giving up any of its rights or claims, it is very difficult to see what objection there could in principle be to a company accepting a surrender of its fully paid-up shares. But such cases are unlikely to be frequent.[13] In the Bellerby case[14] Cozens-Hardy, L.J., expressed an obiter dictum that a surrender of even fully paid up shares involved an unlawful reduction of capital. This view can be supported only if we regard the surrendered shares as no longer issued shares.

In that case Cozens-Hardy and Stirling, L.JJ., were of the opinion, also obiter as the case related to partly paid shares, that a company can accept surrenders only in circumstances which would justify a forfeiture and that therefore a company can never accept a surrender of fully paid-up shares. This view would seem to be too narrow. The English courts have upheld surrenders of shares under a bona fide scheme of capital reconstruction not involving a reduction of issued or paid-up share capital as a whole.[15]

The question of a company accepting a surrender of partly paid-up shares presents less difficulty. Such surrenders will result in the reduction of the issued and unpaid share capital which can be done only with the confirmation of the court. Such transactions are really tantamount to a company repurchasing the issued shares because in consideration of a member giving up a partly paid share, the company agrees to waive its right to call up the unpaid amount on the shares. The decision in the Bellerby case that a company cannot accept a surrender of partly paid-up shares has never been doubted or challenged.

But the Calcutta decisions which recognize a general power of forfeiture of shares would equally sanction a general power to accept surrenders because, according to the learned judges of the Calcutta High Court, there will be no reduction of capital, if the forfeited or surrendered shares are not to be extinguished, but reissued. It is submitted that this view is misconceived and that the validity of a forfeiture or surrender ought not to be made dependent on whether the surrendered or forfeited share will be extinguished or reissued by the company.

Conclusion

Many a basic tenet of company law as it obtains in our country calls for re-examination: e.g. the distinction between public and private companies; the requirement of seven or two minimum subscribers for public and private companies; the doctrine of ultra vires, constructive notice and indoor-management; insider-trading; director's duty of skill and care; etc. Many a basic tenet of our law of corporation finance equally calls for re-examination: e.g., the requirement of a par value for shares; minimum paid-up capital; the law of dividend. When we decided to have a new Companies Act after we became independent, we should perhaps have undertaken a thorough-going reform of the law beginning from the scratch. Perhaps this will become necessary or desirable sometime in the future.

The provisions dealing with reduction of share capital have only served to create conceptual ambiguities and hide and distort policy perspectives in many important areas of the law of corporation finance.

Footnotes

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1. Sch. 1, Table A, Articles 29-35. On lien see Articles 9-12.

2. Companies Act, 1956, SS.100-105.

3. Counsel so argued in the Hope and Dronfield cases, infra n.7.

4. 4 Ch. D. 827 (1877).

5. 41 Ch. D. 1 (1889).

6. (1894) 2 Ch. 239.

7. Hope v. Int'l Financial Society, 4 Ch. D. 327 (C.A.1876); In re Dronfield Silkstone Coal Co., 17 Ch.D. 76 (C.A.1880); Trevor v. Whitworth, 12 App. Cas. 409 (H.L.1887).

8. (1917) 1 Ch. 646.

9. Mohta v. Mohta, 63 Cal.531 (1936); Sanyal v. Roy, (1945) 2 Cal. 105; Calcutta Stock Exchange Assn., Ltd. v. Nundy & Co., (1950) 1 Cal.235.

10. Sri Gopal Jalan & Co. v. Calcutta Stock Exchange Assn., Ltd., (1963) 2 S.C.J. 505.

11. Nundi v. The Calcutta Stock Exchange Assn., Ltd., A.I.R. (1949) Cal.337.

12. Teasdale's Case, 9 Ch.54 (1873); Eichbaum Case, (1891) 3 Ch.459; Rowell Case, (1912) 2 Ch. 609.

13. See Kirby v. Wilkins, (1929) 2 Ch.444, followed in Re Castiglione's Will Trusts, (1958) 1 All E.R.480.

14. (1902) 2 Ch. 14.

15. See the cases cited supra n.12