Week 5
Topic 7
Share capital types, shares and shareholders' rights

Textbook Chapters 16

Share Capital Learning Objectives

- Meaning of shares and share capital
- Allotment of shares
- Classes of shares
- Preference shares and variation of class rights
- Maintenance of share capital
- Financial assistance
- Share buy-backs
- Declaration of dividends, payable out of ”profits” and effect of contravention

Chapter 16 – Share capital, shares and shareholders’ rights

- Company Finance
- The nature of share capital
- Dividends
- Shareholders’ rights

Company Finance

16-001 to 16-120

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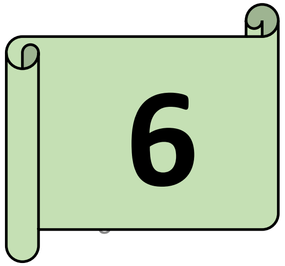
Increasing issued capital – types of issue

- What are the main types of share issue:
  - **Initial public offering or new float** – large public scale, to list a company on SGX
  - **Private placement** – large parcels of shares offered to small number of investors, generally at a discount
  - **Rights issues** – offer to existing shareholders on a *pro-rata* basis, usually priced at a discount, either renounceable (can sell the rights) or non-renounceable (cannot sell the rights)
  - **Dividend reinvestment plans** (scrip dividend scheme) – get paid in shares instead of dividend
  - **Bonus issues** – company issues shares to existing shareholders *pro-rata* without them paying for the shares



Increasing issued capital - underwriting

- What is underwriting?
- An underwrite (stock-broking firm or financial intermediaries) offer to take up the remaining shares during an offer.
- The underwriter gets paid a fee in return for this promise.
- The underwrite may transfer part of their risks by contracting with sub-underwriters to take up some of the shares, the sub-underwriters are also paid a fee for this.

	DEBT	EQUITY
Payments to investors	Interest at an agreed rate that the company is contractually bound to pay	Dividends payable only out of profits if declared by the directors
Repayment of principal	Parties usually expect repayment of the principal at the end of the term	Usually, no expectation that equity capital will be repaid to members while the company is a going concern
Priority	Lender has priority over members for payment of interest and repayment of principal	
Membership	Lender is not a member	Equity holder is a member, with membership rights (such as voting rights)
Right to share in surplus assets on a winding up	After repayment of principal, no right to participate	May participate in surplus assets, depending on the terms of issue of the shares

Table 16.1 Differences between Debt and Equity

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The Nature of Share Capital

16-200 to 16-260

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The nature of share capital

What is share capital?

- The company's share capital is the amount of money or assets contributed to the company by its members when they subscribe for shares in the company
- S161 CA – empowers company to issue shares

What is a share?

- A share in a limited company is a claim against the company to which the rights set out in the *Companies Act* and the company's constitution attach
- Distribution rights (dividends, surplus during winding up)
- Control rights (voting)
- S121 CA – sets out legal nature of shares
- Intangible property called "chose in action" *(a right to sue)* – can be dealt with by shareholders like any personal property – sold, mortgaged, bequest

The nature of share capital - classes of shares

- **What are classes of shares?**
  - Whether or not a company has the power to issue shares of different types, or ‘‘classes’’, is determined by the company’s constitution
- **Rights attached to different classes of shares:**
  - Entitlement to dividend payments
  - Voting rights
  - Priority in repayment of capital on winding up
  - Rights to share in surplus of assets on winding up
- **Why do companies issue different classes of shares?**
  - Entrench control in the hands of certain shareholders (different voting rights, right to nominate directors)
  - Issue shares that have many characteristics of debt (preference shares)
  - Establish separate classes of shares to participants in a joint venture
  - Issue shares that participate differently in company’s profits (different parts of profits streamed to particular family members for tax or commercial reasons)

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The nature of capital - restrictions

- What **restrictions** on the rights can be attached to shares?
  - Private companies can issue shares with varying rights with no restrictions
  - In the past, public companies could only issue one-vote-one-share, now this restriction is lifted;
  - Now public companies can issue multiple-vote and non-voting shares, provided that the issue of the shares is provided for in the company's constitution and the constitution sets out the rights of the shares.
  - Shareholders must approve of the issue by way of special resolution, instead of ordinary resolution, accompanied by a notice of meeting
  - Holders of non-voting shares are entitled to vote on resolutions to wind up the company and those that vary the rights of non-voting shares.

The nature of share capital - ordinary shares

What are **ordinary shares**?

- Not defined in CA – shares which companies limited by shares ordinarily issue at the time of incorporation.
- They typically have these rights:
  - The right to share equally in any dividends (if they are declared) with all other ordinary shareholders, after all other claimants have been paid
  - The right to vote at a general meeting of the company
  - The right to be repaid their capital (or a *pro rata* share of it) on a winding up after all other claimants have been repaid; and
  - The right to share *pro rata* in any surplus assets on a winding up

The nature of share capital - preference shares

What are **preference shares**?

- A preference share is usually understood to have special rights which given them preference in respect of certain matters over ordinary shares.
- They typically have these rights:
  - The right to receive a fixed dividend provided there are profits available for distribution and a dividend is declared by the company
  - The right to be repaid the principal on a winding up in priority to ordinary shareholders
  - No voting rights unless dividends are in arrears, except on resolutions to reduce the company’s capital or wind up the company, or at class meetings on matters affecting their class rights; and
  - Generally, no right to share in surplus assets on a winding up

The nature of share capital - preference shares

- It be be noted that companies are free to decide what special rights they wish to attach to preference shares.
- **S75 CA** states that rights of preference shareholders with respect to prepayment of capital, participation in surplus assets and profits, cumulative or non-cumulative dividends, voting and priority of payment of capital and dividend in relation to other shares or other classes of preference shares are to be set out in the company's constitution.
- Different types of preference shares:
    - Cumulative preference shares
    - Non-cumulative preference shares
    - Redeemable preference shares
    - Convertible preference shares

The nature of share capital - partly paid shares

- What are partly paid shares?
  - Only part of the subscription price for a share has been paid to the company at the time the share is issued, with the balance to be paid at a later date

The nature of share capital - call

- What is a call?
  - Where a company has issued partly paid shares, the company is entitled to make a ‘‘call’’ at a later time for some or all of the balance owing on the share
  - Once a call is made, the shareholder is liable to pay
  - The procedure with regards to calls on shares and interest that is payable for late payment on calls are set out in the company’s constitution
  - Companies may issue partly paid shares to “lock in” a commitment for significant funding in the future.
  - Companies may also issue partly paid shares to particular people the rights of shareholders (voting and dividend rights) without requiring them to put up the full amount of the subscription price at the outset.

The nature of share capital - option

- What are options?
  - An option is a right to buy or sell something at a pre-agreed price at (or by) some agreed time in the future
  - Examples of options:
    - Options over unissued shares – entitles the option holder to subscribe for shares at an agreed price (or at a price to be calculated by reference to an agreed formula) at or by specific time in the future.
    - Options over issued shares –issued shareholders grant to others (takers) the right or obligation to acquire the option-writer’s (seller’s) shares in the future.
- Who are the parties to an option contract?
  - Purchaser (taker) and seller (writer).
  - The purchaser pays the seller an amount (option premium) to acquire the right conferred by the option

Option terminologies

Put option	An option that carries the right to sell a share. The person who holds the option has the right to require the other party to buy the share at the agreed exercise price.
Call option	An option that carries the right to buy a share. The person who holds the option has the right to require the other party to issue or sell them the share at the agreed exercise price.
Option premium	The price paid by the purchaser to acquire the option.
Exercise price or strike price	The price payable to exercise the option and buy the underlying security.
American style options	Options that are exercisable at any time up to an agreed expiry date.
European style options	Options that are exercisable only on the agreed expiry date.

[Call and Put Options Explained]

Dividends payable only out of profits

17-500 to 540

Dividends payable only out of profits

- **Restrictions**
  - Companies may pay dividends only out of profits: sec 403(1) of the *Companies Act*
  - To allow dividends to be paid out of capital would amount to a return of capital to members
- **What are profits?**
  - Profits not defined in CA
  - Availability of profits is not the same as availability of cash.
  - UK position - distributions may be made out of accumulated realised gains minus accumulated realised losses according to accounting standards
  - New amendment in CA – gains derived by the company from the sale or disposal of treasury shares are not payable as dividends (s403(1C)); but proceeds otherwise received by the company as consideration for the sale or disposal of treasury shares which the company has applied towards the profits are payable as dividends (s403(1A) and (1B)).
  - Generally, court is reluctant to interfere with management decisions with respect to monetary payments to persons associated with the company
  - So a company does have considerable latitude to determine payments without contravening s403 CA

Dividends payable only out of profits

- **What are the consequences of a breach of s403?**
- Directors who willfully pays or permits dividends to be paid out of what he knows is not profit is guilty of an offence and may be liable to creditors of the company for the amount due by the company to them to the extent by which dividends paid have exceeded the profits – s403(2)(b) CA.
- Directors who allowed a dividend to be paid when there were no profits would also breach his fiduciary duty by misapplying the company funds. The creditors or liquidator may recover this amount from the director.

Tutorial Question 5 - Dividend

A company made a trading profit of $100,000 in the current year. The directors wish to declare the maximum amount of dividends legally allowed. In doing so, the directors proposed the following:

(a) to ignore a debit balance of $80,000 in the profit and loss appropriation account, representing losses over the past five years;

(b) to distribute a further $100,000 being the amount by which land purchased seven years previously, was revalued upwards in the current year. The revaluation was on the basis of what the directors' thought would be reasonable in the next couple of years;

(c) to disregard a fall in the market value of shares held by the company for the purpose of deriving income from dividends. Advise on the legality of these proposals.

Shareholders' Rights

16-400 to 16-480

Shareholders' rights

What rights do shareholders have?

- The rights that attach to shares may include:
    - Voting rights
    - Distribution rights
    - Rights to receive information; and
    - Where the shares are divided into more than one class, class rights

Shareholders’ rights – voting rights

- On what matters can shareholders vote?
  - At general meetings (see chapter 7) – adoption of and amendment to company’s constitution; changes of company name and type; variation of class rights and share issue, buy-back and reduction of capital
  - Appointment and removal of directors
  - Directors’ remuneration
  - Appointment and removal of auditors
- Voting rights
  - The number of votes shareholders have depend on the constitution
  - Both public and private companies can issue shares with different voting rights
- When can preference shareholders vote?
  - Defined in the company’s constitution as required by s75 CA.

Shareholders' rights – distribution rights

Distribution rights

- Describes a shareholder's entitlement to receive money or other assets from the company; in the form of
  - Dividends, paid out of profits – s403 CA
  - Return of capital for the amount originally subscribed on winding up and share buy-back
  - An entitlement to share in the company's surplus assets on a winding up

Shareholders' rights – the right to receive information

- The right to receive information
- Purpose:
  - Transparency
  - Helps shareholder decide if action has to be taken against wrongdoers
- Main information rights:
  - Information is available to the public generally through search in ACRA's records
  - Additional rights are:
    - Right to inspect company's registers
    - Right to attend general meeting and to speak on resolution – s180 CA
    - Right to be notified about certain corporate events
    - Right to inspect minutes of meetings – s189 CA
    - Right to receive annual financial reports – s203 CA

Shareholders' rights – class rights

- Where a company has issued shares of different classes, or is proposing to issue shares of a new class, the rights attaching to each class are referred to as ''class rights"
- S64A CA – public companies can only issue different classes of shares if the issue is provided for in the constitution and the constitution sets out the rights attached to the various classes of shares.
- S75 CA – issue of preference shares – the terms of issue must be set out in the constitution.
- For other shares – possible for the rights attaching to particular classes of shares to be set out in a company's resolution or in the terms of issue of the shares themselves
- The existence of a class depends on the commonality of interest between different members. IF members have different rights attaching to their shares, then those shares are treated as being in different classes.

Shareholders' rights – class rights

- When are class rights varied or cancelled?
    - It is necessary to decide
        - Whether what is being varied or cancelled is a class right; and
        - Whether what is being done amounts to a variation or cancellation of the right
- Class rights are deemed to be varied under s74(6) CA -
    - The <u>issue by a company of preference shares ranking pari passu</u> with <u>existing preference shares</u> issued by the company shall be deemed to be a <u>variation of the rights</u> attached to those existing preference shares <u>unless</u> the issue of the first-mentioned shares was <u>authorised by the terms of issue of the existing preference</u> shares or by the constitution of the company in force at the time the existing preference shares were issued
    - Eg preference shareholders are entitled to 10% preferential dividend. If additional preference shares are issued such that the original shareholders have to share the profit, then their rights are deemed to be varied.

Shareholders' rights – class rights

- When are class rights varied or cancelled?
  - S74(7) CA - The alteration of any provision in the constitution of a company which affects or relates to the manner in which the rights attaching to the shares of any class <u>may be varied or abrogated shall be deemed to be a variation or abrogation</u> of the rights attached to the shares of that class
- s74A CA – permits a company whose share capital is divided into different classes to make provision in its <u>constitution to authorize the conversion of one class of shares into another class of shares</u>. However, a share that is not redeemable preference share when issued cannot be converted into a redeemable preference shares

Shareholders' rights – class rights

- How are class rights protected:
  - By modification of rights clause in the constitution – according to a procedure set out in the constitution
  - By applying to court under sec 74 – if rights of a class of shareholders are deemed to be varied, class shareholders with no less than 5% issued shares in that class may apply to the Court to have the variation cancelled.
  - By entrenching provisions governed by sec 26A – requires a specified majority greater than 75% or requires other specified conditions are met before variation
  - Difference between modification of rights (procedural) and entrenching provisions (may only be removed of all the members agree– s26A(2))
  - Modification of rights clause can be an entrenching provision if fulfilled s26A(1) – if inserted at formation or subsequently when all the members agree to insert

Shareholders' rights – class rights

- General law when voting –
  - Class shareholders must vote in good faith for the benefit of the class as a whole.
  - Re Holders Investments Trust [1971]

    90% of Shareholders in preference shares class voted to cancel cumulative preference shares in exchange for unsecured loan stock. This would benefit the ordinary shareholders as they stood to gain on dividends. The 90% preference shareholders also happened to hold 52% of ordinary shareholders. The court held that they did not vote in good faith for the benefit of the shareholders in preference shares class.

Shareholders' rights – class rights

- Rights of dissenting members –
  - S74(1) CA – holders of not less than 5% shares in that class may apply to the court to have the variation or abrogation cancelled; if such an application is made, the variation or abrogation shall not have effect until confirmed by the court.
  - However, member can only activate this section if there is a modification of rights clause in the constitution.
  - If there is no such clause, a member can seek protection under s216 CA – minority protection section if he can show that the resolution is prejudicial to "one or more members … including himself"
  - Under s74 – the court can only confirm or disallow the resolution; however, under s216, the court has power to make such order as it thinks fit.