2 In what circumstances will an agent bind a company to a contract made with a third party? What effect does the company's constitution have on the power of agents to bind companies to such contracts? (*The Institute of Chartered Secretaries and Administrators*)

3 B is the managing director of T Ltd. He has decided that the company should have a new factory built. He arranges for P Ltd to carry out the building work on the usual standard term contract for the building industry which requires that T Ltd makes progress payments on a three-monthly basis.

The articles of association of T Ltd provide that the directors of the company may negotiate any contract on the company's behalf up to a value of £100,000 but contracts in excess of this sum must be approved by the company passing an ordinary resolution in general meeting.

The value of this building contract is £500,000. B did not obtain the approval of the general meeting. The first progress payment has now fallen due and the other directors of T Ltd have resolved not to pay it on the grounds that the contract was not properly authorised by the shareholders.

You are required to explain whether T Ltd is bound to pay this progress payment and more generally whether T Ltd is bound to the contract with P Ltd.

(*The Chartered Institute of Management Accountants*)

4 (a) What is the rule in ***Royal British Bank* v *Turquand*** (1856), and what defences against its application are available to a company?

(b) Beetlecrush Ltd was a company involved in pest control. In 1999 Pellet was appointed as managing director of the company by a board resolution, which gave him exclusive power to manage the company, subject only to a requirement to get the approval of the board for all contracts in excess of £50,000.

On behalf of the company, Pellet began negotiating for the purchase of insecticides from Toxin, who had supplied the company with similar products for a number of years. Before these negotiations were concluded, Toxin accepted an invitation to become a member of the board of Beetlecrush Ltd, and thenceforth duly attended its board meetings. Some months after this, Pellet, without getting the approval of the board, signed a contract with Toxin for the supply of £80,000 worth of insecticides.

Preliminary trials with these insecticides have revealed that they are not as effective as the company had been hoping. The board, with the exception of Pellet and Toxin, is now seeking some way in which the company can claim that it is not bound by its obligations under the contract.

Advise the board. (*The Association of Chartered Certified Accountants*)

5 Contrast the rules governing contracts purporting to be made on behalf of a company before it has been incorporated under the Companies Act with those governing contracts made by or on behalf of an incorporated company before it is entitled to do business.

(*The Institute of Company Accountants*)

6 The company secretary of Beech Ltd has in the past been permitted to order office equipment and stationery for the company but no single transaction has exceeded £500. Recently, without the knowledge of the directors, he ordered a computer installation costing £200,000. The board does not wish to proceed with the purchase but the supplier is claiming that the company is bound by the contract.

Advise the directors. (*The Institute of Chartered Accountants in England and Wales*)

Test your knowledge

Four alternative answers are given. Select ONE only. Circle the answer which you consider to be correct. Check your answers by referring back to the information given in the chapter and against the answers at the back of the book.

1 Delta plc and Ullswater Ltd have each recently received their certificates of incorporation.

- **A** Delta plc and Ullswater Ltd can now both commence trading and borrow.
- **B** Only Delta plc can trade and borrow.
- **C** Only Ullswater Ltd can trade and borrow.
- **D** Neither Delta nor Ullswater can trade or borrow.

2 A transaction with another company entered into by Tom, a director of Thames Ltd, with the authority of the board is outside the authority of the board under the articles of Thames Ltd but within its objects. The transaction is:

- **A** valid under s 40 of the Companies Act 2006.
- **B** void as being beyond the powers of the board.
- **C** voidable at the option of the members.
- **D** void at the instance of the other party.

3 A managing director of a company has usual (or ostensible) authority to bind the company by his acts. Which of the following sets out the full limit of this authority?

- **A** All commercial activities relating to the running of the business.
- **B** All activities of the company whether commercial or not.
- **C** Such commercial activities as the board chooses to delegate.
- **D** Those commercial activities which the members direct in general meeting.

4 Bob, a non-executive director of Test Ltd, who has no responsibility for the purchasing department, makes a contract on behalf of Test (which is unknown to his fellow directors) to buy goods from a new supplier. What is the legal position of Test?

- **A** It is bound because all matters decided upon by any director bind the company under s 40 of the Companies Act 2006.
- **B** It is not bound because a non-executive director as such does not have usual (or ostensible) authority by reason of office to bind the company.
- **C** It is bound because all the acts of an ordinary director bind the company under ***Turquand***'s case.
- **D** It is not bound because a company is never bound by the acts of one director.

Answers to text your knowledge questions appear on p. 616.

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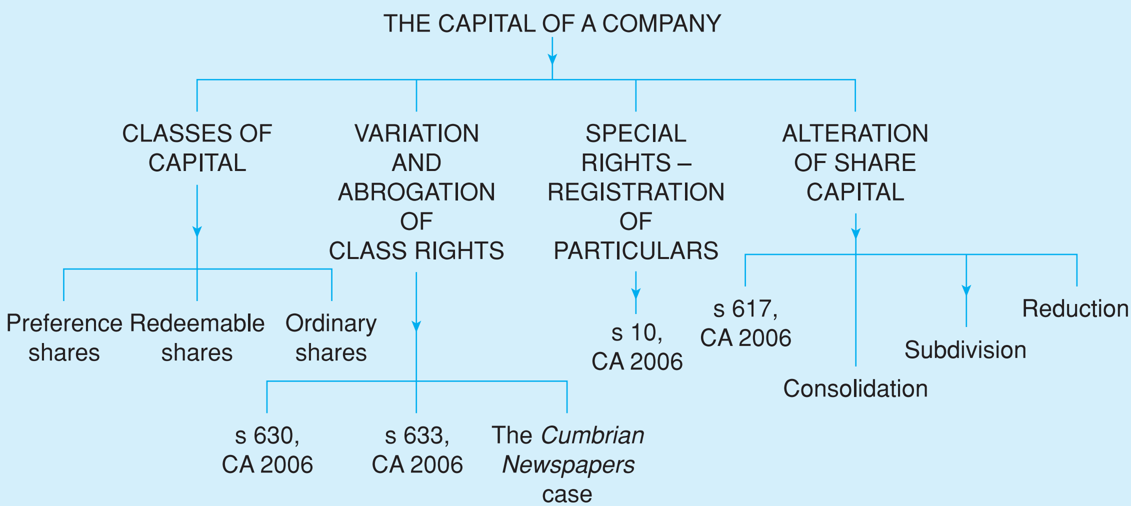
7 The capital of a company



A company may confer different rights on different classes of shares, the main types being preference and ordinary shares. Shares may also be non-voting or have multiple voting rights. In the most extreme situations, shares may also carry additional voting rights on particular resolutions (i.e. to remove a director) as in the case of ***Bushell* v *Faith*** [1970] AC 1099.

There is no implied condition in a company's articles that all of its shares shall be equal (***Andrews* v *Gas Meter Co*** [1897] 1 Ch 361).

Andrews* v *Gas Meter Co [1897] 1 Ch 361

Per Lindley LJ:

> The question raised by this appeal is whether certain preference shares issued by a limited company as long ago as 1865 were validly issued or not . . . The company's original capital as stated in its memorandum of association was '60,000 *l*, divided into 600 shares of 100 *l* each, every share being sub-divisible into fifths, with power to increase the capital as provided by the articles of association'. By the articles of association which accompanied the memorandum of association, and were registered with it, power was given to the company to increase the capital (Art 27), and it was provided that any new capital should be considered as part of the original capital (Art 28). The issue of preference shares was not contemplated or authorised. In 1865 the company desired to acquire additional works, and passed a special resolution under the powers conferred by the Companies Act 1862, ss 50 and 51, altering the articles and authorising the issue of 100 shares of 100 *l* each, fully paid, and bearing a preferential dividend of 5 *l* per cent per annum. Those shares were accordingly issued to the vendors of the works referred to, and are the shares the validity of which is now in question. The company has been prosperous, and the ordinary shareholders have for years received a higher dividend than the preference shareholders. A considerable reserve has also been accumulated, and this action has been brought to determine the rights of the preference shareholders to this reserve fund. The learned judge has held that the creation of the preference shares was *ultra vires*, and that their holders never became and are not now shareholders in the company, and that they have none of the rights of shareholders, whether preference or ordinary. He has not, however, declared more definitely what their rights are. They have appealed from this decision; but on the appeal they only claimed to be preference shareholders entitled to a preferential dividend of 5 per cent. Their claim to any share of the reserve fund was dropped. The judgment against the validity of the preference shares is based upon the well-known case of ***Hutton* v *Scarborough Cliff Hotel Co*** which came twice before Kindersley V-C. in 1865, and which Kekewich J very naturally held to be binding on him. Kindersley V-C's first decision was that a limited company which had not issued the whole of its original capital could not issue the unallotted shares as preference shares unless authorised so to do by its memorandum of association or by its articles of association. This decision was affirmed on appeal and was obviously correct; and would have been correct even if the whole of the original capital had been issued and the preference shares had been new and additional capital. The company, however, afterwards passed a special resolution altering the articles and authorising an issue of preference shares. This raised an entirely different question, and led to the second decision. The Vice-Chancellor granted an injunction restraining the issue of the preference shares, and he held distinctly that the resolution altering the articles was *ultra vires*. He did so upon the ground, as we understand his judgment, that there was in the memorandum of association a condition that all the shareholders should stand on an equal footing as to the receipt of dividends, and that this condition was one which could not be got rid of by a special resolution altering the articles of association under the powers conferred by ss 50 and 51 of the Act . . .
>
> These decisions turned upon the principle that although by s 8 of the Act the memorandum is to state the amount of the original capital and the number of shares into which it is to be divided, yet in other respects the rights of the shareholders in respect of their shares and the terms on which additional capital may be raised are matters to be regulated by the articles of association rather than by the memorandum, and are, therefore, matters which (unless provided for by the memorandum, as

> in ***Ashbury* v *Watson*** may be determined by the company from time to time by special resolution pursuant to s 50 of the Act. This view, however, clearly negatives the doctrine that there is a condition in the memorandum of association that all shareholders are to be on an equality unless the memorandum itself shows the contrary. That proposition is, in our opinion, unsound.

See p. 56

As noted earlier in Chapter 2 under s 9(4), the required contents of the application for registration include a statement of capital and initial shareholdings if the company is to have a share capital. The details of this statement are outlined in s 10 of the Companies Act 2006, providing (under s 10(2)(c)) that for each class of shares it must state:

(a) prescribed particulars of the rights attached to the shares;
(b) the total number of shares of that class; and
(c) the aggregate nominal value of shares of that class.

The importance of this process is reinforced by the wording of s 629(1), which states that 'for the purposes of the Companies Acts, shares are of one class if the rights attached to them are in all respects uniform'. Section 629(2) goes on to note that 'for this purpose the rights attached to shares are not regarded as different from those attached to other shares by reason only that they do not carry the same rights to dividends in the twelve months immediately following their allotment'.

However, beyond these references of 'class rights' the Companies Act 2006 does not provide any further clarification as to the meaning of the term. In this respect, one needs to refer to the case law in the area, in particular that of ***Cumbrian Newspapers*** (below).

Cumbrian Newspapers Group Ltd v *Cumberland & Westmorland Herald* [1986] 3 WLR 26

A company which issued shares to a shareholder and amended its articles to grant the shareholder particular rights to prevent a take-over could not later cancel the articles since the shareholder had rights attached to a class of shares which could not be abrogated. The plaintiff and defendant were both publishers of newspapers. They negotiated a transaction whereby D would acquire one of P's papers and P would acquire 10 per cent of D's share capital. D duly issued the 10 per cent shareholding and as part of the agreement under which the shares were issued amended its articles to grant P rights of pre-emption over other ordinary shares, rights in respect of unissued shares, and the right to appoint a director. The purpose of such rights was to enable P as a shareholder to prevent a takeover of D. After several years, the directors of D proposed to convene an extraordinary general meeting and to pass a special resolution to cancel the articles which gave special rights to P. P sought a declaration that the rights were class rights which could not be abrogated without his consent, and an injunction restraining D from holding the meeting.

Held – granting the declaration – that the special rights granted by the articles were rights which although not attached to any particular shares were conferred on P as a shareholder in D and were attached to the shares held for the time being by P without which it was not entitled to the rights. Accordingly, P had 'rights attached to a class of shares' and since the Companies Act 1985 s 125 (now s 630 under the Companies Act 2006) provided that class rights could not be varied or abrogated without the consent of the class members, the special rights enjoyed by P could not be varied or abrogated without his consent.

In this case Scott J made the following observations with respect to class rights:

> Rights or benefits which may be contained in articles can be divided into three different categories. First, there are rights or benefits which are annexed to particular shares. Classic examples of rights

> of this character are dividend rights and rights to participate in surplus assets on a winding up. If articles provide that particular shares carry particular rights not enjoyed by the holders of other shares, it is easy to conclude that the rights are attached to a class of shares [. . .] A second category of rights or benefits which may be contained in articles would cover rights or benefits conferred on individuals not in the capacity of members or shareholders of the company but, for ulterior reasons, connected with the administration of the company's affairs or the conduct of its business. ***Eley* v *Positive Government Security Life Assurance Co Ltd*** (1875) 1 Ex D 20 was a case where the articles of the defendant company had included a provision that the plaintiff should be the company solicitor [. . .] It is, perhaps, obvious that rights or benefits in this category cannot be class rights. They cannot be described as rights attached to a class of shares [. . .] That leaves the third category. This category would cover rights or benefits that, although not attached to any particular shares, were nonetheless conferred on the beneficiary in the capacity of member or shareholder of the company. The rights of the plaintiff fall, in my judgment, into this category [. . .] In the present case, the rights conferred on the plaintiff were, as I have held, conferred on the plaintiff as a member or shareholder of the defendant. The rights would not be enforceable by the plaintiff otherwise than as the owner of ordinary shares in the defendant. If the plaintiff were to divest itself of all its ordinary shares in the defendant, it would not then, in my view, be in a position to enforce the rights in the articles. But the rights were not attached to any particular share or shares. Enforcement by the plaintiff of the rights granted under the articles would require no more than ownership by the plaintiff of at least some shares in the defendant. Enforcement by the plaintiff of the rights granted under article 12, require the plaintiff to hold at least 10 per cent of the issued shares in the defendant. But any shares would do. It follows, in my judgment that the plaintiff's rights under the articles in question fall squarely within this third category.

Comment

(i) The case is unusual because one generally thinks of rights attaching to a whole class of shares and not to the holder of part only of a class.

(ii) A similar and earlier decision is that in ***Re United Provident Assurance Co Ltd*** [1910] 2 Ch 477 where it was held that shareholders within a class who have paid up different amounts on their shares must be regarded as a separate class and on a variation must meet separately as a class.

The general principle is that the rights enjoyed by one particular class should not be varied by the holders of another class of shares within the company (i.e. it is necessary to gain the consent of the members of the class whose rights are the subject of proposed variation to agree to this process). This process is covered by s 630 of the Companies Act 2006 and necessarily raises the question as to what amounts to a 'variation of rights' for the purposes of this provision (see ***White* v *Bristol Aeroplane*** below). It should be noted that this process is over and above that outlined in s 21 (amendment of the company's articles of association) and provides an important protective function. For example, if the class in question involves preference shares which are non-voting, then without s 630 they may never have an input into the proposed changes to the rights attached to their shares (i.e. the process would be open to exploitation by the majority in general meeting; a majority comprised holders of ordinary shares). As such, the class in question must vote in favour of the proposed amendment in a separate class meeting, followed by the s 21 process in the context of the general meeting. (It is perhaps worth considering the case of ***Allen* v *Gold Reefs*** in this context – see Chapter 5.)

See p. 115

In addition to this, it may be observed that s 22 provides for the entrenchment of provisions of the articles. In other words, that specified provisions may only be amended or repealed if conditions are met, or procedures are complied with that are more restrictive than a special resolution.

Ordinary shares

The nature of an ordinary share is perhaps best understood by comparing it with a preference share. In this way we can ascertain the distinguishing features, and the advantages and disadvantages which arise from the holding of ordinary shares.

Disadvantages

The main perceived disadvantage is the fact that the ordinary shareholder is entitled to a dividend only after the preference dividends have been paid. Furthermore, where the preference shares have preference as to capital, the ordinary shares rank behind the preference shares for repayment of capital on winding-up or where there is a reduction of capital by repayment. The preference shares must be fully repaid first (see further Chapter 8).

See p. 162

It is perhaps because of the above priorities given to preference shareholders that the ordinary shareholders are said to hold the equity share capital of the company, presumably by analogy with the equity of redemption held by a mortgagor in the law of mortgages. A mortgagor who pays off all the charges on his property has the right to redeem or recover it by virtue of this equity; indeed it is the last right he retains, for when that is gone, he has lost his property. Similarly, the equity shareholders are entitled to the remaining assets of the company after the claims of creditors and of preference shareholders have been met.

Advantages

Here we may observe that the voting power of the ordinary shareholders in general meetings is such as to allow them to control the resolutions at such meetings. In fact, this means that the directorate really represents, or can be made to represent, the ordinary shareholders.

It is not uncommon for companies to issue preference shares with no voting rights at general meetings, though if such shares are to be listed on the Stock Exchange, they must be given adequate voting rights by the company's articles. It would seem, however, that the voting rights of preference shareholders are adequate if they can vote:

(a) when their dividend is in arrear;
(b) on resolutions for reducing share capital and winding up the company; and
(c) on resolutions which are likely to affect their class rights (s 630).

A further advantage of ordinary shareholders is that their dividends are not fixed and may rise considerably with the profitability of the company.

A final advantage is that a company may issue bonus shares for which the shareholder does not pay in cash, or make new issues (called rights issues) at prices lower than outsiders would have to pay, and both of these are generally offered to the company's existing ordinary shareholders.

Preference shares

These shares are entitled to preferential treatment when dividends are declared. Thus, a 10 per cent preference share must receive a dividend of 10 per cent out of profits before anything can be paid to the ordinary shares. Since there may be several classes of preference shares ranking one after the other, it is essential to ascertain the precise rights of a holder of a particular preference share.

However, a right to preferential dividend without more is deemed a right to a cumulative dividend (i.e. if no dividend is declared on the preference shares in any year, the arrears are carried forward and must be paid before any dividend can be declared on ordinary shares (***Webb* v *Earle*** (1875) LR 20 Eq 556)). Thus, if the 10 per cent preference shares mentioned above received dividends of 5 per cent in 1999; 5 per cent in 2000; and nothing in 2001; they would be entitled at the end of 2002 to 5 + 5 + 10 + 10, or 30 per cent before the ordinary shareholders could have a penny.

However, it may be expressly provided by the terms of issue that they are to be non-cumulative but it is rare nowadays to find such a provision in the case of shares issued by public companies; and they may be held to be non-cumulative by implication, as where the terms of issue or the articles provide that dividends shall be paid 'out of yearly profits' (***Adair* v *Old Bushmills Distillery*** [1908] WN 24) or 'out of the net profits of each year' (***Staples* v *Eastman Photographic Materials Co*** [1896] 2 Ch 303).

Preference shares do not carry the right to participate in any surplus profits of the company unless the articles so provide (***Will* v *United Lankat Plantations Co*** [1914] AC 11). However, it is possible to create cumulative and participating preference shares, conferring on the holders of such shares a right to participate in surplus profits up to a given percentage, e.g. a right to a preferential dividend of 6 per cent plus a further right, after, say, 10 per cent has been paid to ordinary shareholders, to participate in surplus profits until a further 6 per cent has been paid but no more.

Arrears of preference dividend in a winding-up

In the absence of an express provision in the articles, no arrears of preference dividend are payable in the winding-up of a company unless the dividend has already been declared (***Re Crichton's Oil Co*** [1902] 2 Ch 86) and this is so even where the articles provide for the payment of dividends due at the date of winding-up, for a dividend is not due until declared (***Re Roberts and Cooper Ltd*** [1929] 2 Ch 383). Where the articles do provide for payment of arrears, they may be paid out of the surplus assets after payment of the company's debts, even though those assets do not contain any undistributed profits (***Re Wharfedale Brewery Co*** [1952] Ch 913). Thus, the general rule that dividends must not be paid out of capital does not apply in this sort of situation. However, unless there is a specific provision which says so, the right to arrears ceases at the date of liquidation (***Re E W Savory Ltd*** [1951] All ER 1036).

Even where the articles or terms of issue do contain a provision regarding the repayment of dividend and/or capital to preference shareholders in a winding-up, problems of construction arise, i.e. problems arise with regard to the meaning of the words used. For example, in ***Re Walter Symons Ltd*** [1934] Ch 308, preference shares were issued with 'the right to a fixed cumulative preferential dividend at the rate of 12 per cent per annum on the capital for the time being paid up thereon [. . .] and to rank both as regards dividends and capital in priority to the ordinary shares *but with no right to any further participation in profits or assets*'. The court took the view that the italicised words envisaged a winding-up, because it is only in winding up that the question of participation in assets arises. Therefore, the rest of the clause must also apply in a winding-up, and the preference shares had priority in a winding-up for repayment of dividends unpaid at that date.

However, in ***Re Wood, Skinner and Co Ltd*** [1944] Ch 323, the preference shareholders had 'the right to a fixed cumulative dividend of 6 per cent per annum on the capital paid up on the shares', and were expressed to rank 'both as regards dividends and capital in priority to the ordinary shares'. In this case the court decided that since the latter part of the clause did not refer solely to the winding-up situation, the priority conferred was restricted to dividends declared while the company was in operation, and did not give the right to arrears of dividend once a winding-up had commenced.

Of course, a person drafting terms of issue today would normally make his intentions more clear than was done in the two cases cited above, and would certainly not use the phrases which were used then. Nevertheless, problems do arise out of bad draftsmanship and the cases show how the court might deal with such situations.

A typical modern clause in the terms of issue of preference shares which more clearly expresses the rights intended to be conferred is as follows.

> The holders of preference shares shall be entitled to a fixed cumulative preferential dividend at the rate of X per cent per annum upon the amount paid up thereon, and in the event of the winding up of the company, to repayment of the amount paid up thereon together with any arrears of dividend calculated to the date of such repayment in priority to the claims of ordinary shares, but shall have no other right to participate in the assets or profits of the company.

It should be noted that under such a clause unpaid preference dividends will be payable for periods up to the repayment of the preference capital, even though the dividends have not been declared and in spite of the fact that the company may not have earned sufficient profits to pay them while it was a going concern (***Re Wharfedale Brewery Co*** [1952] Ch 913).

Repayment of capital on winding-up

Preference shares have no inherent priority as to the repayment of capital in a winding-up. If the assets are not enough to pay the preference and ordinary shares in full then, unless the articles or terms of issue provide to the contrary, preference and ordinary shares are paid off rateably according to the nominal value of their shares (***Birch*** v ***Cropper*** (1889) 14 App Cas 525). Where, as is usual, the preference shares have priority either by the articles or terms of issue, they are entitled to repayment of their capital in full before the ordinary shareholders receive anything by way of repayment of capital. Where there are surplus assets left after the discharge of all the company's liabilities and the repayment of capital to all shareholders, the surplus is divided among ordinary and preference shareholders unless the articles provide to the contrary. Any rights given by the articles are exhaustive. Thus, where the articles give preference shareholders priority of repayment of capital in a winding-up, but do not refer to any further rights in the capital of the company, the preference shareholders have no right to participate in surplus capital (***Scottish Insurance*** v ***Wilsons***).

Scottish Insurance Corporation Ltd v *Wilsons & Clyde Coal Co Ltd* [1949] AC 462

The articles of a company provided inter alia that, in the event of the company being wound up, the preference shares 'shall rank before the other shares of the company on the property of the company to the extent of repayment of the amounts called upon and paid thereon'. The company, whose colliery assets had been transferred to and vested in the National Coal Board, had postponed liquidation till the compensation provided under the Coal Industry Nationalisation Act 1946 had been settled and paid, but as a preliminary step towards liquidation had passed a special resolution for the reduction of capital by which the whole paid-up capital was to be returned to the holders of preference stock.

Held – the holders of preference stock had no right to share in the surplus assets and that consequently it could not be said that the proposed reduction was not fair and equitable between the different classes of shareholders, and that it should therefore be confirmed.

Per Lord Simonds:

> Reading these articles as a whole [. . .] I would not hesitate to say, first, that the last thing a preference stockholder would expect to get (I do not speak here of the legal rights) would be a share of surplus assets, and that such a share would be a windfall beyond his reasonable expectations and, secondly, that he had at all times the knowledge, enforced in this case by the unusual reference in Art 139 to the payment off of the preference capital, that at least he ran the risk, if the company's circumstances admitted, of such a reduction as is now proposed being submitted for confirmation by the court. Whether a man lends money to a company at 7 per cent or subscribes for its shares carrying a cumulative preferential dividend at that rate, I do not think that he can complain of unfairness if the company, being in a position lawfully to do so, proposes to pay him off. No doubt, if the company is content not to do so, he may get something that he can never have expected but, so long as the company can lawfully repay him, whether it be months or years before a contemplated liquidation, I see no ground for the court refusing its confirmation . . .
>
> It is clear from the authorities, and would be clear without them, that, subject to any relevant provision of the general law, the rights *inter se* of preference and ordinary shareholders must depend on the terms of the instrument which contains the bargain that they have made with the company and each other. This means, that there is a question of construction to be determined and undesirable though it may be that fine distinctions should be drawn in commercial documents such as articles of association of a company, your Lordships cannot decide that the articles here under review have a particular meaning, because to somewhat similar articles in such cases as ***In Re William Metcalfe & Sons Ltd*** that meaning has been judicially attributed. Reading the relevant articles, as a whole, I come to the conclusion that Arts 159 and 160 are exhaustive of the rights of the preference stockholders in a winding up. The whole tenor of the articles, as I have already pointed out, is to leave the ordinary stockholders masters of the situation. If there are 'surplus assets' it is because the ordinary stockholders have contrived that it should be so, and, though this is not decisive, in determining what the parties meant by their bargain, it is of some weight that it should be in the power of one class so to act that there will or will not be surplus assets . . .
>
> But, apart from those more general considerations, the words of the specifically relevant articles, 'rank before the other shares . . . on the property of the company to the extent of repayment of the amounts called up and paid thereon', appear to me apt to define exhaustively the rights of the preference stockholders in a winding up. Similar words, in ***Will* v *United Lankat Plantations Co Ltd*** 'rank, both as regards capital and dividend, in priority to the other shares', were held to define exhaustively the rights of preference shareholders to dividend, and I do not find in the speeches of Viscount Haldane LC or Earl Loreburn in that case any suggestion that a different result would have followed if the dispute had been in regard to capital. I do not ignore that in the same case in the Court of Appeal the distinction between dividend and capital was expressly made by both Cozens-Hardy MR and Farwell LJ, and that in ***In re William Metcalfe & Sons Ltd*** 51 Romer LJ reasserted it. But I share the difficulty, which Lord Keith has expressed in this case, in reconciling the reasoning that lies behind the judgments in ***Will***'s case 53 and ***In re William Metcalfe & Sons Ltd*** respectively.

The following is, therefore, a summary of the position:

(a) Where the preference shareholders have no priority in regard to repayment of capital, they share the assets rateably with the ordinary shareholders, including any surplus assets left after repayment of share capital and other liabilities.

(b) If the articles or terms of issue give the preference shareholders priority for repayment of capital, they are repaid the nominal value of their shares before the ordinary shareholders but no more.

In addition, it should be noted that if the articles give preference shareholders an express right to participate equally with the ordinary shareholders in surplus assets, they are entitled to share in such assets even though they include ploughed back profits of former years which could have been distributed as dividend to ordinary shareholders but which instead were placed in reserve (***Dimbula Valley (Ceylon) Tea Co Ltd*** **v** ***Laurie*** [1961] 1 All ER 769). The fact that the ordinary shareholders are, while the company is a going concern, in charge of the profit, i.e. they can resolve upon a distribution within the provisions of Part VIII of the Companies Act 1985, does not prevent the preference shareholders having a right to participate in those profits which the ordinary shareholders have left undistributed.

Variation and abrogation of class rights

If the shares of a company are divided into different classes (e.g. ordinary and preference), the expression 'class rights' refers to the special rights of a particular class of shareholder concerning, e.g. dividends and voting and rights on a winding-up. The Companies Act 2006 makes it clear that abrogation of class rights is included. This means that class rights can be extinguished entirely as well as merely varied provided the appropriate procedures of s 630 as set out below are followed. However, the process outlined in s 630 must be complied with, over and above that outlined in s 21 which deals with the amendment of the company's articles by way of a special resolution. Consequently, there is a built-in protective mechanism for those within the company who enjoy class rights.

1 Meaning of variation

Case law decided that class rights are to be regarded as varied only if after the purported act of variation they are different in substance from before as where the company proposes to make its existing cumulative preference shares non-cumulative. Unless this is so, consent of the particular class or classes of shareholders is not required. The courts have in general taken a narrow and, perhaps, over-literal approach to the meaning of variation of rights. For instance, in ***Adelaide Electric Co*** **v** ***Prudential Assurance*** [1934] AC 122, HL, the court held that the alteration of the place of payment of a preferential dividend did not vary the rights of the preference shareholders (despite the fact that the exchange rate acted in favour of the company and against the preference shareholders).

Another example has already been given in ***Greenhalgh*** **v** ***Arderne Cinemas***, 1946. In particular, the creation of new rights in others does not amount to a variation if existing rights are preserved. Thus, Boxo Ltd has 'A' ordinary shares with one vote each and 'B' ordinaries with one vote each. If the company increases the voting power of the 'A' ordinaries to two votes per share, is that a variation of the rights of the 'B' ordinary shares? From the decision in Greenhalgh, it would seem not.

Other cases which are worth reading so as to gain an interesting insight into the approach adopted by the courts in this area are as follows: ***Re Saltdean Estate Co Ltd*** [1968] 1 WLR 1844

See p. 169 (see Chapter 8); ***Prudential Assurance Co* v *Chatterly Whitfield Collieries*** [1949] AC 512; ***Re John Smith's Tadcaster Brewery Co*** [1953] Ch 308, CA. The following cases are also of interest.

House of Fraser plc* v *ACGE Investments [1987] 2 WLR 1083

In this case the House of Lords decided that where a company pays off and cancels cumulative preference shares (which have priority for repayment of capital in the company's articles) in a capital reduction there is no need for a class meeting of the preference shareholders to approve this. In the circumstances their rights have not been varied but merely put into effect. One of the rights attached to the preference shares was the right to a return of capital in priority to other shareholders when any capital was returned as being in excess of the company's needs. That right was not being affected, modified, dealt with or abrogated. It was merely being put into effect. The company was granting the preference shareholders their rights, not denying them.

White* v *Bristol Aeroplane [1953] Ch 65

The defendant company had sent out notices of proposed resolutions to increase the ordinary and preference stock of the company from GBP 3,900,000 to GBP 5,880,000, of which GBP 660,000 preference stock was to be distributed to the ordinary shareholders by new issues. There was a certain equilibrium between the ordinary stock and the preference stock, and it was objected that that equilibrium would be upset when the new shares were issued to the detriment of the preference stockholders and that their rights were 'affected' within the meaning of Art 68 of the company's articles and that the company could not carry out the proposed plan without first obtaining a vote of the preference stockholders. Art 68 provided:

> All or any of the rights or privileges attached to any class of shares forming part of the capital for the time being of the company may be affected modified varied dealt with or abrogated in any manner with the sanction of an extraordinary resolution passed at a separate meeting of the members of that class. To any such separate meeting all the provisions of these articles as to general meetings shall *mutatis mutandis* apply [. . .]

Held – on appeal – the provisions of the articles were inconsistent with the view that any variation which in any manner touched or affected the value of the preference stock or the character or enjoyment of any of the holders' privileges was within the contemplation of Art 68; the question was whether the rights of the preference stockholders were 'affected', not as a matter of business, but according to the meaning of the articles when construed according to the rules of construction and as a matter of law; those rights would not be affected by the proposed resolution, and, consequently, the appeal must be allowed.

In this regard, Evershed MR noted:

> The question then is – and, indeed, I have already posed it – are the rights which I have already summarised 'affected' by what is proposed? It is said in answer – and I think rightly said – No, they are not; they remain exactly as they were before; each one of the manifestations of the preference stockholders' privileges may be repeated without any change whatever after, as before, the proposed distribution. It is no doubt true that the enjoyment of, and the capacity to make effective, those rights is in a measure affected; for as I have already indicated, the existing preference stockholders will be in a less advantageous position on such occasions as entitle them to register their votes, whether at general meetings of the company or at separate meetings of their own class. But there is to my mind a distinction, and a sensible distinction, between an affecting of the rights and an affecting of the enjoyment of the rights, or of the stockholders' capacity to turn them to account.

2 Method of variation or abrogation

The method by which the variation or abrogation was effected under the Companies Act 1985 depended upon the source of the class rights. In other words, the process under s 125 of the 1985 Act was dependent upon whether the rights were conferred by the company's memorandum, articles of association, or even by way of the resolution setting out the terms of issue. This inevitably led to a rather complex process.

By contrast, s 630 of the Companies Act 2006 sets down a single, straightforward rule. (This has been made possible in part by the reforms surrounding the reduced role which the memorandum now plays in the day-to-day running of a company under s 8.) Consequently, s 630(2) states that variation of the rights attached to a class of shares may only be varied:

(a) in accordance with provisions in the company's articles for the variation of class rights; or
(b) where the company's articles contain no such provision, if the holders of shares of that class consent to the variation in accordance with this section.

Section 630(4) goes on to provide that the consent required under s 630(2)(b) is either (a) consent in writing from the holders of at least three-quarters in nominal value of the issued shares of that class; or (b) a special resolution, passed at a separate general meeting of the holders of that class, sanctioning the variation.

Consequently, a resolution to vary the rights of a particular class is of no legal effect unless the consent of the class is obtained. However, it should be borne in mind that any vote on a resolution to modify class rights must be undertaken for the purpose (or predominant purpose) of benefiting the class as a whole (***British America Nickel Corporation Ltd* v *O'Brien*** [1927] AC 369).

British America Nickel Corporation Ltd* v *O'Brien [1927] AC 369

A company, incorporated in Canada, issued mortgage bonds secured by a trust deed, which gave power to a majority of the bondholders, consisting of not less than three-fourths in value, to sanction any modification of the rights of the bondholders. A scheme for the reconstruction of the company provided for the mortgage bonds being exchanged for income bonds subject to an issue of first income bonds; also that a committee, one only of whom was to be appointed by the mortgage bondholders, should have power to modify the scheme without confirmation by the bondholders. The scheme was sanctioned by the majority of the bondholders requisite under the trust deed. The required majority would not have been obtained but for the vote of the holder of a large number of bonds, whose support of the scheme was obtained by the promise of a large block of ordinary stock, an arrangement which was not mentioned in the scheme. Viscount Haldane stated:

> To give a power to modify the terms on which debentures in a company are secured is not uncommon in practice. The business interests of the company may render such a power expedient, even in the interests of the class of debenture holders as a whole. The provision is usually made in the form of a power, conferred by the instrument constituting the debenture security, upon the majority of the class of holders. It often enables them to modify, by resolution properly passed, the security itself. The provision of such a power to a majority bears some analogy to such a power as that conferred by s 13 of the English Companies Act of 1908, which enables a majority of the shareholders by special resolution to alter the articles of association. There is, however, a restriction of such powers, when conferred on a majority of a special class in order to enable that majority to bind a minority. They must be exercised subject to a general principle, which is applicable to all authorities conferred

> on majorities of classes enabling them to bind minorities; namely, that the power given must be exercised for the purpose of benefiting the class as a whole, and not merely individual members only. Subject to this, the power may be unrestricted. It may be free from the general principle in question when the power arises not in connection with a class, but only under a general title which confers the vote as a right of property attaching to a share. The distinction does not arise in this case, and it is not necessary to express an opinion as to its ground. What does arise is the question whether there is such a restriction on the right to vote of a creditor or member of an analogous class on whom is conferred a power to vote for the alteration of the title of a minority of the class to which he himself belongs . . .
>
> [T]heir Lordships do not think that there is any real difficulty in combining the principle that while usually a holder of shares or debentures may vote as his interest directs, he is subject to the further principle that where his vote is conferred on him as a member of a class he must conform to the interest of the class itself when seeking to exercise the power conferred on him in his capacity of being a member. The second principle is a negative one, one which puts a restriction on the completeness of freedom under the first, without excluding such freedom wholly.
>
> The distinction, which may prove a fine one, is well illustrated in the carefully worded judgment of Parker J in ***Goodfellow* v *Nelson Line***. It was there held that while the power conferred by a trust deed on a majority of debenture holders to bind a minority must be exercised bona fide, and while the Court has power to prevent some sorts at least of unfairness or oppression, a debenture holder may, subject to this vote in accordance with his individual interests, though these may be peculiar to himself and not shared by the other members of the class. It was true that a secret bargain to secure his vote by special treatment might be treated as bribery, but where the scheme to be voted upon itself provides, as it did in that case, openly for special treatment of a debenture holder with a special interest, he may vote, inasmuch as the other members of the class had themselves known from the first of the scheme. Their Lordships think that Parker J accurately applied in his judgment the law on this point . . .
>
> Their Lordships are of opinion that judgment was rightly given for the respondents in this appeal. It is plain, even from his own letters, that before Mr JR Booth would agree to the scheme of 1921 his vote had to be secured by the promise of $2,000,000 ordinary stock of the Nickel Corporation. No doubt he was entitled in giving his vote to consider his own interests. But as that vote had come to him as a member of a class he was bound to exercise it with the interests of the class itself kept in view as dominant. It may be that, as Ferguson JA thought, he and those with whom he was negotiating considered the scheme the best way out of the difficulties with which the corporation was beset. But they had something else to consider in the first place. Their duty was to look to the difficulties of the bondholders as a class, and not to give any one of these bondholders a special personal advantage, not forming part of the scheme to be voted for, in order to induce him to assent.

Held – that the resolution was invalid, both because the bondholder in voting had not treated the interest of the whole class of bondholders as the dominant consideration, and because the scheme, so far as it provided for a committee, was *ultra vires*.

It is also worth noting at this point that according to s 630(5), any attempt to amend a provision contained in the articles for the variation of the rights attached to a class of shares is to be treated as a variation of those rights.

3 Right to object to variation

Dissentient members of a class may object to variation. The holders of not less than 15 per cent of the issued shares of the class, being persons who did not consent to or vote for the resolution to vary, may apply to the court to have the variation cancelled (s 633). If such application is made, the variation has no effect until confirmed by the court.

Application to the court must be made within 21 days after the date on which the resolution was passed or the consent given (s 633(4)). It may be made on behalf of all the dissentients by one or more of them appointed in writing. The variation then has no effect unless and until confirmed by the court (s 633(3)). The court's power on hearing a petition for cancellation of a variation of class rights is limited to approving or disallowing the variation. The court cannot amend the variation or approve it subject to conditions.

The company must send to the Registrar within 15 days of the making of the court order, a copy of that order embodying the court's decision on the matter of variation (s 635(1)).

Alteration of share capital

A company's share capital may be altered or increased provided the company follows the appropriate methods and procedures.

1 Alteration of share capital

A limited company, having a share capital, may not alter its share capital except in the ways outlined in s 617 of the Companies Act 2006.

2 Consolidation of capital

According to s 618, a limited company may consolidate its capital by amalgamating shares of smaller amount into shares of larger amount (e.g. by consolidating groups of 20 shares of nominal value 5p into shares of nominal value £1). It is rarely that a company needs to consolidate, the tendency being to subdivide and go for lower nominal values which makes the shares easier to sell, since shares in public companies generally sell on the Stock Exchange for more than nominal value.

Section 619 goes on to note that notice of consolidation must be given to the Registrar within one month, specifying the shares affected. In addition, s 619(2) states that this must be accompanied by a statement of capital, which under s 619(3) must state:

(a) the total number of shares of the company;
(b) the aggregate nominal value of those shares;
(c) for each class of shares; (i) prescribed particulars of the rights attached to the shares; (ii) the total number of shares of that class; and (iii) the aggregate nominal value of shares of that class; and
(d) the amount paid up and the amount unpaid on each share.

3 Subdivision of shares

This would occur, for example, where a company subdivides every £1 share into 10 shares of 10p each. However, the proportions of amounts paid and unpaid must remain the same where the shares are partly paid. For example, if before subdivision every £1 share was 50p paid, then the new shares of 10p each must be treated as 5p paid. The company cannot regard some of the new shares as fully paid and some as partly paid. A company may wish to subdivide shares to make them more easily marketable, e.g. a share having a nominal value of £1 may have a market value of £8 and this may restrict market dealings. If the company subdivides its shares into shares of 10p each, the market price would be 80p per share and dealings would be facilitated.

This is covered by ss 618–619 and follows a similar process to that outlined above for the consolidation of capital.

4 Reduction of share capital

A limited company may reduce its share capital, by special resolution confirmed by the court (see ss 645–651), or in the case of a private company limited by shares, by special resolution supported by a solvency statement (see ss 642–644). Furthermore, s 641 provides that a company may not reduce its share capital if, as a result of the reduction, there would be no longer any member of the company holding shares other than redeemable shares (see below).

Redeemable shares

Sections 684 and 689 of the Companies Act 2006 allow the issue of redeemable shares whether equity or preference.

The provisions are designed, among other things, to encourage investment in the equity of small businesses in circumstances where the proprietors, often members of a family, can at an appropriate stage buy back the equity investments without parting permanently with family control.

Issue of redeemable shares

A limited company may issue redeemable shares (s 684(1)) and may be issued as redeemable at the option of the company or the shareholder. Under s 684(2), the articles of private limited companies may either exclude or restrict the issue of redeemable shares, but a public limited company may only issue redeemable shares if authorised to do so by its articles (s 684(3)).

Redeemable shares may be issued only if there are in issue other shares which cannot be redeemed (s 684(4)). If a company's shares were all redeemable it could redeem the whole of its capital and end up under a board of directors with no members. This would circumvent provisions which have already been considered in Chapter 1 and which are designed to prevent a company continuing in existence without any members.

The redemption of redeemable shares

Redeemable shares may not be redeemed unless they are fully paid (s 686(1)). The issued capital is the creditors' buffer and it is this figure and not the paid-up capital which must be replaced.

The terms of the redemption may, under s 686(2), provide that the amount payable on redemption may, by agreement between the company and the holder of the shares, be paid on a date later than the redemption date.

Financing the redemption

Redeemable shares may only be redeemed out of distributable profits or out of the proceeds of a fresh issue of shares (which need not be redeemable) made for the purpose (s 687(2)). Any premium payable on redemption must be paid out of distributable profits of the company (s 867(3)), unless the shares being redeemed were issued at a premium (see below).

Section 688 provides that shares, when redeemed, are to be cancelled and this will reduce the issued share capital of the company by the nominal value of the shares redeemed.

If the shares being redeemed were themselves issued at a premium, then s 687(4) provides that any premium on their redemption may be paid out of the proceeds of a fresh issue of shares made for the purposes of 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.

Furthermore, under s 687(5), 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 out of the proceeds of the issue of the new shares.

See p. 162

The object of the above provisions is to tighten protection for creditors on a redemption (or purchase, see Chapter 8) of shares.

In company law the creditors' buffer, as it is called, is the company's share capital plus non-distributable reserves (i.e. reserves that cannot be written off to pay dividends, such as the capital redemption reserve and the share premium account). Under the above formula the share premium account can only be written down to the extent of the amount of the new issue of shares that will replace the amount so written down, thus replacing with share capital what has been written off the share premium account and so preserving the buffer.

Miscellaneous matters relating to redeemable shares

Time of redemption

Redeemable shares can be made redeemable between certain dates. The holder thus knows that his shares cannot be redeemed before the earlier of the two dates, which is normally a number of years after the issue of the shares, in order to give him an investment which will last for a reasonable period. He also knows that the shares are bound to be redeemed by the later of the two dates mentioned.

However, there are no legal provisions requiring the company to fix the time of redemption at the time of issue though as we have seen there is no reason why this should not be done by, for instance, making the shares redeemable at the option of the company between stated dates. Section 685 provides that the redemption of shares may be effected in such a manner as may be provided by the company's articles or by a resolution of the company.

As regards failure to redeem (or purchase) its shares, a company cannot be liable in damages for such a failure. The shareholder may obtain an order for specific performance unless the company can show that it cannot meet the cost of redemption out of distributable profits.

In addition, following statements by Megarry J in ***Re Holders Investment Trust*** [1971] 2 All ER 289, a shareholder whose shares are not redeemed on the agreed date may be able to obtain an injunction to prevent the company from paying dividends either to ordinary shareholders or to any subordinate class of preference shareholder until the redemption has been carried out. ***Re Holders*** also confirms that such a shareholder may petition for a winding-up under s 122 of the Insolvency Act 1986 – the just and equitable ground.

If the company goes into liquidation and at the date of commencement of the winding-up has failed to meet an obligation to redeem (or purchase) its own shares, and this obligation occurred before the commencement of the winding-up, the terms of the redemption (or purchase) can be enforced by the shareholder against the company as a deferred debt in the liquidation, but not if during the period between the due date for redemption (or purchase) and the date of commencement of the winding-up the company could not have lawfully made a distribution (see further Chapter 8) equal in value to the price at which the shares were to have been redeemed (or purchased).

See p. 162

Any money owed is deferred to claims of all creditors and preference shareholders having rights to capital which rank in preference to the shares redeemed (or purchased) but ranks in front of the claims of other shareholders.

Notice to the Registrar of redemption

Notice of redemption must be given, under s 689, to the Registrar within one month of the redemption. Failure to do so is an offence covered by s 689(5).

Essay questions

1 (a) Distinguish between ordinary and preference shares.

(b) Shark plc has a share capital of £150,000. It is divided into 50,000 £1 preference shares and 100,000 £1 ordinary shares. All shares have been issued. The rights attached to the preference shares include the right to have capital repaid before the ordinary shareholders in the event of the company being wound up. The articles contain no such provision. The articles are also silent on how to vary class rights.

Advise Shark plc on whether and how it may convert its preference shares into ordinary shares. (*Glasgow Caledonian University*)

2 Distinguish between preference shares, participating preference shares and ordinary shares. (*The Institute of Chartered Accountants in England and Wales*)

3 'A company is contractually bound by the actions of its directors when those directors act within their authority.'

You are required to discuss this statement. (*The Chartered Institute of Management Accountants*)

4 With specific reference to the facts and principle of law in ***Salomon* v *Salomon & Co Ltd***, discuss corporate identity and the occasions when it is set aside. (*University of Paisley*)

5 Tom and Dick wish to form a company to manufacture wooden hen houses to be called Cluck Ltd. Explain the procedure for incorporation and commencement of business. (*The Institute of Company Accountants*)

6 ‘A secretary is a mere servant; his position is that he is to do what he is told, and no person can assume that he has any authority to represent anything at all . . .’ per Lord Esher in ***Barnett Hoares & Co*** v ***South London Tramways Co*** (1887).

To what extent does the statement reflect the current status of a company secretary?

(*The Institute of Chartered Accountants in England and Wales*)

Test your knowledge

Four alternative answers are given. Select ONE only. Circle the answer which you consider to be correct. Check your answers by referring back to the information given in the chapter and against the answers at the back of the book.

1 Where rights are attached to a class of shares set out in a company’s statement of capital and initial shareholdings and the company’s constitution and the articles do not contain any provision regarding the way in which the rights may be varied then they may be varied by:

- A a special resolution of the company.
- B a special resolution of the company and the consent of the holders of three-quarters of the class of shares in question.
- C the agreement of all the members of the company in general meeting.
- D an extraordinary resolution of the holders of the class in question.

2 Boxo Limited has varied the class rights of one of its classes of shares. What proportion of the owners of those shares who did not consent to or vote for the variation can make an application to the court to have the variation cancelled, and within what time must they apply?

- A The holders of not less than 15 per cent of the issued shares of the class whose rights were varied within 21 days of the passing of the resolution.
- B The holders of not less than 10 per cent of the issued shares of the class within 28 days of the resolution being passed.
- C The holders of not less than 15 per cent of the issued shares of the class within 28 days of the resolution being passed.
- D The holders of 21 per cent of the issued shares of the class within 15 days of the resolution being passed.

3 Where would a preference shareholder go to ascertain the rights attaching to the shares?

- A To the share certificate.
- B To the share certificate and the memorandum of association.
- C To the articles of association only.
- D To the articles of association and/or the terms of issue.

4 What type of resolution is required at a general meeting to increase the nominal capital?

- A An ordinary resolution.
- B A special resolution following special notice.
- C A special resolution.
- D An extraordinary resolution.

5 What type of resolution must be passed in general meeting in order that there may be a valid alteration of the company's articles?

- **A** A special resolution with special notice to the company.
- **B** An ordinary resolution following special notice to the company.
- **C** A special resolution.
- **D** An ordinary resolution.

Answers to test your knowledge questions appear on p. 616.

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8 Capital maintenance – generally