
LESSON 2

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STUDY TEXT

RAISING AND MAINTENANCE OF CAPITAL

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1. RAISING OF CAPITAL

1.1 MEANING OF CAPITAL

In commercial parlance, the word 'capital' is generally used to denote the amount by which the assets of a business exceed its liabilities. However, in legal parlance the word "capital" is used to denote the amount of money which a company raises from a sale of its shares, or what represents that money.

1.2 TYPES OF CAPITAL

A company's capital at any given moment may consist of:

a) NOMINAL OR AUTHORISED CAPITAL

This is the capital that is stated in the memorandum of association pursuant to S.5 (4) a) of the Act. It is called "nominal capital" because it is calculated on the basis of the "nominal" or book value of the shares into which it is divided. It is 'authorised' in the sense that, once the memorandum of association is registered, the company can take immediate steps to raise the capital from the public without applying for a permit or license to collect the money.

b) ISSUED CAPITAL

The issued capital is that portion of the nominal capital which is constituted by the nominal value of the shares which have been issued by the company. It is also known as the "subscribed capital" or "allotted capital". It may be less than, or equal to, the nominal capital but cannot exceed it.

c) PAID-UP CAPITAL

The paid-up capital is constituted by the aggregate of the amount of money that is paid-up on each share issued by the company. It may be equal to or less than, the issued capital but cannot exceed it.

d) CALLED-UP CAPITAL

A company's called-up capital is constituted by the amount due in respect of calls made by the directors on issued shares.

e) UNCALLED CAPITAL

The uncalled capital is the amount not called up on shares which a company has issued. It is the nominal capital minus the called up and the paid-up capital.

f) RESERVE CAPITAL

The reserve capital is defined by S.62 of the Act as the portion of the issued but uncalled capital of a limited company which the company's members, by special resolution, have resolved that the company shall not call up unless and until it is in liquidation. It is to be called up only for purposes of the liquidation. As soon as the resolution is passed, the capital is, as it were, "put on reserve". The directors' power under the articles to make calls on shares will not be exercisable in respect of that capital, unless the company is being wound up. It is referred to in the marginal note to S.62 as "the reserve liability" of a limited company.

1.3 METHODS OF PUBLIC ISSUE

A company's authorised capital may be raised in one or the other of the following ways:

a) PLACING

A 'placing' occurs if the company, instead of selling its shares directly to the public, arranges with a broker to sell them on its behalf.

Company.....Broker sells the shares to.....Public
(acts as the
company's agent)

The shares are said to be "placed" with the broker. A placing may be "a private placing" if the shares are to be offered for sale to selected customers of the broker (usually institutional investors) rather than made available to the general public.

b) OFFER FOR SALE

An "offer for sale" is an arrangement whereby a company sells some of its shares to a financial institution called "Issuing House". The issuing house will then re-sell the shares to the public.

Company.....sells shares to.....Issuing House.....Resells the shares to Public
(Issues a document called
"Offer for sale")

The company normally issues renounceable allotment letters to the issuing house to facilitate the transfer of specific shares to designated purchasers. This obviates the necessity of having to register the name of the issuing house in the company's register of members when shares are allotted to it and having its name removed from the register shortly afterwards when the public buy the shares.

c) PROSPECTUS ISSUE

Under a prospectus issue the company sells the shares directly to the public rather than selling them through intermediaries.

Company.....sells shares to Public
(Issues a document
called "prospectus")

1.4 THE PROSPECTUS ISSUE AND STATUTORY PROVISIONS

1.4.1 PURPOSE OF THE STATUTORY PROVISIONS

A company's shares are legally regarded as goods. Consequently, the common law rule known as "caveat emptor" applied to their sale. In particular, the company as a seller was not bound to say anything to potential buyers which would enable them to assess the risks involved. Buyers were therefore left without a legal remedy if they bought shares which they would not have bought if the relevant material facts had been disclosed by the company's agents. In an attempt to remedy this situation the Companies Act incorporated a number of statutory provisions which must be complied with. The provisions are as follows:

1.4.2 THE STATUTORY PROVISIONS

i) Definition of "Prospectus"

A prospectus is defined by S.2 as "any prospectus, notice, circular, advertisement or other invitation offering to the public for subscription or purchase any shares or debentures of a company" This particular definition was intended to prevent companies from evading the legal duties pertaining to the issue of a prospectus by issuing a prospectus under such name as "notice", "circular" or "advertisement". Whether a particular document is a prospectus will ultimately depend on the function it fulfills rather than the name given to it by its authors. Regarding the word "offering" in the definition it should be remembered that the issue of a prospectus by a company is not an offer as such but is a mere "invitation to treat". It is the application made in response to the prospectus that will constitute the "offer"

ii) Dating of the prospectus

s.39 provides that a prospectus shall be dated. The date shall, unless the contrary is proved, be taken as the date on which the prospectus was issued to the public.

iii) Contents of the prospectus

The authors of a prospectus are legally free to state therein whatever they deem appropriate to state but the contents must include, where applicable, the eighteen matters specified in Part I of the Third Schedule to the Act and the three reports specified in Part II of the said Schedule. Section 40(3) provides that, except as provided therein, it shall not be lawful for a company to issue any form of application for shares in or debentures of a company unless the form is issued with a prospectus which complies with the statutory requirements. However, a form of application for shares need not be issued with a prospectus if the form was issued either:-

- i) in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to the shares or debentures; or
- ii) in relation to shares or debentures which were not offered to the public; or

- iii) to existing members or debenture holders of the company (irrespective of whether the applicant had the right to renounce in favour of other persons); or
- iv) in relation to shares or debentures which are or are to be in all respects uniform with shares or debenture previously issued.

1.4.3 THE MATTERS AND REPORTS

The matters and reports to be stated in a prospectus may be summarised as follows:

1. The Matters

The matters to be stated in a prospectus are:

- i) Directors' and Auditors of the company
 - a) Directors' names, addresses and occupations.
 - b) Directors' qualification shares, if any, and their remuneration (if there is a provision in the articles).
 - c) Directors' interest in the company's promotion.
 - d) Auditors' names and postal addresses.
- ii) Formation expenses
 - a) Preliminary expenses.
 - b) Promoters' remuneration.
 - c) Particulars of options on shares or debentures.
 - d) Underwriting commission and brokerage.
- iii) Investor information
 - a) The minimum subscription.
 - b) The time of the opening of the subscription lists.
 - c) Amount payable on application and allotment.
 - d) Voting and class rights
 - e) Deferred shares.
- iv) Company's property and business
 - a) Particulars of shares and debentures issued otherwise than for cash.
 - b) Particulars of material contracts.
 - c) Vendors of property to the company.
 - d) Amount paid for property to be bought by the company, stating the amount paid for goodwill.
 - e) Length of time the business has been carried on, if less than three years.

2. The Reports

- i) An auditor's report showing:
 - a) Profits or losses in each of the last FIVE years.
 - b) Rate of dividend during the last five years.
 - c) Assets and liabilities at the date of the last accounts.
 - d) Similar details with regard to subsidiary companies, if any.
- ii) Where the proceeds of the issue are to be used to buy a business, a report by named accountants on the profits or losses of the business for the last five years, and its assets and liabilities at the date of the last accounts.
- iii) Where the proceeds of the issue are to be used to buy shares in a subsidiary, a similar report as in (ii) above.

1.4.4 MEANING OF "PUBLIC"

For the purposes of the prospectus issue the word "public" is declared by S.57 (1) to include "any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner."

In Re: South of England Natural Gas Co. Ltd (40) it was held that a document inviting applications for shares in certain gas companies was an offer to the public even though it was marked "for private circulation only." However, a "circular" by which a company offered to acquire the shares of another company in exchange for its own shares was held not to be a "prospectus" within the statutory definition: Government Stock and other Securities Investment Co. Ltd v Christopher (41)

1.4.5 REGISTRATION OF PROSPECTUS

S.43 (1) provides that no prospectus shall be issued by or on behalf of a company unless, on or before the date of its publication, there has been delivered to the registrar for registration a copy thereof signed by every person who is named therein as a director or proposed director of the company, or by his agent authorised in writing and having endorsed thereon or attached thereto—

- a) an expert's consent to its issue (if the prospectus contains a statement by him), and
- b) a copy or memorandum of every "material contract" and a written statement signed by the named accountants or auditors indicating any adjustments to their report and the reasons for the adjustments (if the prospectus was issued generally.)

1.4.6 LIABILITIES IN RESPECT OF PROSPECTUSES

1. CRIMINAL LIABILITIES

- i) Issuing a form of application unaccompanied by a full prospectus: a fine not exceeding Shs.10,000/- (S.40 (4)).

- ii) Where a prospectus "includes any UNTRUE STATEMENTS":-
 - a) Fine not exceeding Shs. 10,000/- or
 - b) Imprisonment for a term not exceeding two years,
or
 - c) Both such fine and imprisonment S.46 (1)
- iii) Knowingly issuing a prospectus containing a statement purporting to be made by an expert without the expert's consent to the issue thereof: fine not exceeding Shs. 10,000/- (S.42 (2)).
- iv) S.43 (5) imposes a fine not exceeding Shs.100/- per day for:-
 - a) Issuing a prospectus without delivering a signed copy thereof to the registrar for registration.
 - b) Issuing a prospectus containing an expert's statement and delivering a signed copy thereof to the registrar for registration, but the copy so delivered does not have endorsed thereon (or attached thereto) the expert's consent to the issue of the prospectus,
 - c) Issuing a prospectus and delivering a signed copy thereof to the registrar for registration, but the copy so delivered does not have endorsed thereon (or attached thereto)-
 - i) a copy of every material contract (or a memorandum thereof) or
 - ii) a written statement signed by the named accountants or auditors indicating any adjustments to their reports and the reasons for the adjustments.

2. CIVIL LIABILITIES

i) LIABILITY FOR FAILURE TO STATE ANY MATTER OR REPORT

At Common Law, a contract of allotment is not a contract Uberrimae Fidei. The company is therefore not under a legal obligation to disclose or state in its prospectus any relevant matter or report. The allottee of shares has, therefore, no remedy against the company if he bought the shares which he would not have bought had the company made the relevant disclosure. This rule has not been changed by the disclosure requirements of the Companies Act.

However, the allottee may have a remedy for an omission if the failure to state any relevant fact had the indirect effect of rendering a stated fact untrue, with S.48 (a) of the Act. For example, in COLES v WHITE CITY (MANCHESTER) GREYHOUND ASSOCIATION LTD the prospectus stated that the land to be acquired by the company was "eminently suitable" for greyhound racing. No mention was made of the fact that approval of the local council was required in order to build public stands and kennels. This was held by the Court of Appeal to be a ground for rescission by the plaintiff.

ii) LIABILITY FOR MISSTATEMENT OR MISREPRESENTATION

This will be governed by the general principles of the law of contract, depending on whether the misstatement was:-

a) A FRAUDULENT MISREPRESENTATION because the company made it—

- i) knowingly, or
- ii) recklessly, careless whether it be true or false, or
- iii) without belief in its truth: DERRY v PEEK (42)

b) AN INNOCENT MISREPRESENTATION because the company made it honestly, believing what was stated to be true: DERRY v PEEK (42)

- 1 If the statement amounted to a fraudulent misrepresentation, the allottee may sue for damages; DERRY v PEEK. But the House of Lords held in HOULDSWORTH v CITY OF GLASGOW BANK that the allottee can only get damages if he is also in a position to rescind the contract of allotment. If the rescission is no longer possible, there will be no remedy. This is an exception to the general principle of the law of contract that a person who has been induced to enter in a contract by a fraudulent misrepresentation has the option of affirming the contract but suing for damages.
- 2 If the statement amounted to an INNOCENT misrepresentation, the allottee CAN ONLY SUE FOR RESCISSION (i.e. asking the court to order the company to remove his name from the members' register and refund the money he paid for the shares and he in turn returning the shares to the company). Damages cannot be awarded for an innocent misrepresentation. This was held by the House of Lords in DERRY v PEEK (42)

However, the allottee's right of rescission (whether for innocent or fraudulent misrepresentation) will be lost if—

- a) He did not institute rectification proceedings within a reasonable time after becoming aware of the misrepresentation: FIRST NATIONAL REINSURANCE CO. V. GREENFIELD (43). in seven months' delay was held to be unreasonable delay.
- b) He affirmed, or is deemed to have affirmed the contract after discovering the truth (e.g. by accepting dividends, attending and voting at meetings, selling or attempting to sell the shares).
- c) Third party rights acquired in the meantime would be interfered with, or
- d) The company has gone into liquidation and so the rights of creditors have crystallized and precede other claims: HOULDSWORTH Vs CITY OF GLASGOW BANK.

EFFECT OF RESCISSION

Where a contract of allotment is rescinded, the former shareholder will be entitled to his money back (normally with interest) and to a refund of any expenses to which he has been put: RE: BRITISH GOLD FIELDS OF WEST AFRICA LTD. The plaintiff will also be entitled to have the company's registers RECTIFIED by deleting his name therefrom, and he can prove in the company's liquidation for the amount due to him: RE: BRITISH GOLD FIELDS OF W. AFRICA.

iii) CIVIL LIABILITY OF DIRECTORS AND PROMOTERS

Any person who subscribed for any shares or debentures on the faith of the prospectus may sue for compensation under S.45 of the Companies Act.

The section is limited to prospectuses issued by or on behalf of the company and will afford no relief on an offer for sale or placing by existing holders (unless the company has made the allotment with that in view, so that S.47 applies).

The section cannot be invoked by market purchasers of securities after the original allotment.

The only persons who can be made liable under the section are:-

- a) directors at the time of the issue of the prospectus;
- b) persons who consented to be named in the prospectus as directors or future directors;
- c) promoters of the company, and
- d) every person who authorised the issue of the prospectus.

S.45 (2) states that "no person shall be liable... if he proves...". This means that the directors or promoters are prima facie liable thereunder unless they successfully avail themselves of the statutory defenses under the subsection, (i.e. they are presumed to be liable until they prove their innocence).

In CLARK V URQUHART (44) the court explained that the amount of compensation payable under S.45 of the Act is calculated or measured in the same way as damages for fraudulent misrepresentation is measured. The court also explained that the word "compensation" was chosen in order to avoid the "invidious association" of damages with dishonesty in such a situation". The specified persons were to be made liable as a matter of policy, irrespective of their moral innocence.

A person sued under S.45 can rebut the presumption of liability by proving that—

- i) having consented to become a director he withdrew his consent before the issue of the prospectus and that it was issued without his authority or consent; or
- ii) the prospectus was issued without his knowledge or consent, and that

on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or authority; or

- iii) after the issue of the prospectus and before allotment thereunder he, on becoming aware of the untrue statement, withdrew his consent to the prospectus and gave reasonable public notice that he had done so and why; or
- iv) as regards every untrue statement not purporting to be made on the authority of an expert or of a public official document or statement, he had reasonable ground to believe that the statement was true; or
- v) the statement was made by an expert and the expert consented to the inclusion of his statement in the prospectus and that he believed the expert to be competent to make the statement; or
- vi) the statement was taken from a public official document or was made by an official, and was a correct and fair representation of the document or statement.

If an expert consented to the inclusion of his report in the prospectus and the report is false he would not be liable if he proves -

- i) that he withdrew his consent in writing before the prospectus was delivered for registration; or
- ii) that after the prospectus was delivered for registration but before the allotment, he, on becoming aware of the untrue statement, withdrew his consent in writing and gave reasonable public notice of the withdrawal, and the reason therefor; or
- iii) that he was competent to make the statement and up to the time of allotment believed on reasonable grounds that it was true.

1.5. ALLOTMENT OF SHARES

An allotment, legally, is the company's acceptance of an offer to buy its shares. It is governed by the following rules of the common law relating to contract.

- a) Where a company issues a prospectus, the issue is an invitation to treat but not an offer. It is not regarded as an offer because of practical reasons: if it was regarded as an offer, every application made pursuant thereto would constitute an acceptance and the company would be contractually bound to allot all the shares applied for. If the issue was oversubscribed, the company would be sued by the applicants who were not given the shares they had applied for. As this appears to be unjust the English courts have avoided the eventuality by regarding the issue of the prospectus merely as an invitation to treat. When applications are made, they will constitute offers. The company would then find out how many shares had been applied for and, if the issue is oversubscribed, accept applications which equal the shares available and reject the others. The company would not be sued by those to whom shares have not been allotted because there would be no contract between them and the company. They made offers which were not accepted by the company - and the company could not accept the various offers because it did not have shares to sell.
- b) The company's acceptance must be unconditional. If, therefore, the application was for 10 shares and only 5 were allotted, the allotment would be a counter-offer which the allottee

could reject. But this might be the only reasonable or just thing for the company to do if the issue was over-subscribed. In order to overcome the legal problem, companies invariably prepare application forms which contain a clause to the effect that the applicant "agrees to accept" such number of shares as the company in its absolute discretion may allot to him.

- c) The acceptance must be communicated to the applicant. This means that the allottee must actually receive the letter of allotment so that he is aware of the allotment. If the letter of allotment is lost in transit there would be no binding contract. However, it was explained in Household Fire Insurance Co. Ltd v Grant (46) that, if the applicant expressly or impliedly authorised the company to communicate the acceptance by post, there would be a binding contract the moment the letter of acceptance is posted. It is irrelevant that the letter was delayed or, as in that case, was lost in transit. In such a case the Post Office would be regarded as the applicant's agent and delivery of the letter of allotment to the post office would legally be equivalent to its delivery to the applicant himself—in accordance with the principles of the law of agency.
- d) The allotment must be made within a reasonable time: Ramsgate Victoria Hotel Co v Montefiore (47).

The above common law rules have been modified by the following statutory provisions:

i) VOID ALLOTMENTS

- a) S.50 A renders an allotment void if it was made to a body corporate which is not a registered company without the prior written consent of the Treasury. This section was presumably "slotted in" in order to prevent public funds given by the Treasury to parastatal organisations from being invested in bogus companies "owned" by some of the senior personnel in parastatals.
- b) S.53 (1) renders an allotment void if it was made before applying for, or obtaining, stock exchange permission for the company's shares to be dealt in on the stock exchange. This is only applicable in cases where the prospectus had stated that the permission had been, or would be, applied for.

ii) VOIDABLE ALLOTMENTS

An allotment of shares is voidable if it is made in breach of—

- a) Section 49 (1): by having been made before the minimum subscription was raised or subscribed, or before the sum payable on application for the shares applied for was paid to, and received by, the company. The "minimum subscription" is defined in paragraph 4 of the Third Schedule as the minimum amount which, in the opinion of the directors, must be raised by the issue in order to provide for the following matters -
 1. The price of any property to be paid for out of the proceeds of the issue.
 2. The preliminary expenses and underwriting commission;
 3. Repayment of money borrowed by the company for (1) and/or (2); and
 4. Working capital.

If a company has not raised the minimum subscription it should not allot any shares but should wait and see if further applications would be made. S.49 (4) provides that

if the minimum subscription has not been raised on the expiration of sixty days after the issue of the prospectus, all money received from applicants for shares shall be forthwith repaid to them without interest. The repayment should be made during the next 15 days. If however any application money is not repaid within seventy-five days after the issue of the prospectus, the directors of the company become personally liable for it and may be sued jointly or severally for the money, with interest thereon at the rate of 5% per annum from the expiration of the seventy-fifth day.

A director would not be liable if he proves that the default in the repayment of the money was not due to any misconduct or negligence on his part.

- b) S.50: by having been made before the statement in lieu of prospectus, if any, was delivered to the registrar for registration.

iii) VALID BUT IRREGULAR ALLOTMENTS

An allotment of shares is valid but irregular under S.52 (3) if it was made before the time of the opening of the subscription lists. The section assumes that:

- a) the allotment was not made in contravention of S.50 A or S.53 so as to be void as a consequence, and
- b) the allotment was not made in breach of S.49 or S.51 so as to be voidable as a consequence.

Although the allotment is valid, the company and every officer of the company who is in default shall be liable to a fine not exceeding ten thousand shillings.

1.6 RETURN AS TO ALLOTMENTS

Section 54 (1) provides that whenever a company limited by shares or a company limited by guarantee and having a share capital makes any allotment of its shares, the company shall, within sixty days thereafter, deliver to the registrar for registration -

- i) A return of the allotments (on Form No.213), stating:
 - a) the number and nominal amount of the shares allotted,
 - b) the names, addresses and descriptions of the allottees, and
 - c) the amount, if any, paid or due and payable on each share.
- ii) In the case of shares allotted as fully or partly and paid up otherwise than in cash, a contract in writing constituting the title of the allottee to the allotment together with any contract of sale, or for services or other consideration in respect of which that allotment was made, such contracts being duly stamped, and a return (on Form No.213) stating the number and nominal amount of shares so allotted, the extent to which they are to be treated as paid up, and the consideration for the allotment.

If such a contract is not in writing, the prescribed particulars of the contract must be filed on Form No.221. The form must be stamped with the same stamp duty as would have been payable if the contract had been reduced to writing.

1.7 COMMENCEMENT OF BUSINESS

Section III (1) provides that a public company which has issued a prospectus cannot commence business or exercise any borrowing powers unless:-

- a) the minimum subscription has been raised; and
- b) every director of the company has paid to the company on each of the shares taken or contracted to be taken by him and for which he is liable to pay in cash, a proportion equal to the proportion payable on application and allotment on the shares offered for public subscription; and
- c) no money is or may become liable to be repaid to applicants for any shares or debentures which have been offered for public subscription by reason of any failure to apply for or to obtain permission for the shares or debentures to be dealt in on any stock exchange; and
- d) there has been delivered to the registrar of registration a statutory declaration by the secretary or one of the directors, in Form No.211, that the aforesaid conditions have been complied with.

If the minimum subscription was not raised the company can only commence business or exercise borrowing powers if:-

- a) there has been delivered to the registrar for registration a statement in lieu of prospectus;
- b) Every director of the company has paid to the company, on each of shares taken or contracted to be taken by him and for which he is liable to pay in cash, a proportion equal to the proportion payable on application and allotment on the shares payable in cash; and
- c) there has been delivered to the registrar for registration a statutory declaration in Form No.212 by the secretary or one of the directors that condition b) above has been complied with.

The registrar shall, on delivery to him of the relevant form, or statement in lieu of prospectus, certify that the company is entitled to commence business. The certificate is conclusive evidence that the company is entitled to commence business.

Section III (4) provides that any contract made by a company before the date at which it is entitled to commence business shall be provisional only, and shall not be binding on the company until that date. This provision is somewhat ambiguous and it is not clear whether the "provisional" contract binds the other party.

In Re "Otto" Electrical Manufacturing Co (Clinton's Claim) it was held that the company was not liable to pay for the goods which had been sold to it before it obtained the trading certificate. Since it was put into liquidation before obtaining the certificate, the contract did not "become binding" and the liquidator had therefore rightly rejected the claim.

S.219 (c) provides that a company which does not commence its business within a year from its incorporation may be wound up by court.

Section III does not apply to a private company which may therefore legally commence its business as soon as it is incorporated.

2.1. MAINTENANCE OF CAPITAL

- 2.1.1 The issued share capital of a company limited by shares is the primary security for the company's creditors. In Re: Exchange Banking Co (Flitcroft's Case) Jessel, M.R. stated: "A limited company by its memorandum of association declares that its capital is to be applied for the purpose of the business. It cannot reduce its capital except in the manner and with

the safeguards provided by statute... One reason is this—there is a statement that the capital shall be applied for the purposes of the business, and on the faith of that statement, which is sometimes said to be an implied contract with creditors, people dealing with the company give it credit. The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business..."

The Companies Act therefore incorporated various provisions which are intended to ensure that a company's capital:

- i) is not "watered down" as it comes into the company; and
- ii) does not go out of the company once it has been received.

2.1.2 PROVISIONS WHICH PREVENT CAPITAL BEING "WATERED DOWN"

The following are the provisions which are intended to prevent a company's capital being "watered down" as it comes into the company:

1 Issuing shares at a discount

In Ooregum Gold Mining Co of India Ltd v Roper (45) the House of Lords held that it is illegal for a limited company to issue its shares at a discount. This decision was made on the basis of what is now S.5 (4) of the Act which provides that the memorandum shall state the amount with which the company will be registered and "the division thereof into shares of a fixed amount". Since the nominal value of a share is fixed by the memorandum the company cannot issue the share at a discount.

After the above case was decided, s.59 of the Act was incorporated so as to permit a company to issue its shares at a discount if—

a) The shares are of a class already issued.

If the shares are of a class already issued, they will most likely have a market value. The market value would provide a basis upon which the company's directors would recommend, and the members resolve on, the amount of the discount. In the absence of such a market value any amount decided on as the new price for the shares would be as arbitrary as the original nominal value.

b) The issue is authorised by a resolution passed in general meeting.

This provision places upon the company's members ultimate responsibility for the issue at a discount.

c) The resolution specifies the maximum rate of discount

It is the members who determine, to a large extent, the market value of the shares. They can therefore jointly decide on the amount below which they would not be willing to sell their shares in the market. The amount so decided on would guide the directors on the maximum amount of discount at which they would be willing to issue the remaining shares, or some of them.

d) Not less than one year has elapsed since the company was entitled to commence business.

This provision obviates the risk of a hasty or premature issue at a discount. The statutory assumption appears to be that, having been in business for at least one year, the company would most likely have published its first balance sheet and declared a dividend which could induce a greater demand for its shares.

e) The issue is sanctioned by the court.

Although the grounds upon which the court is to exercise its discretion to sanction or reject the proposed issue are not spelt out, it appears that it would primarily be acting as the creditors' watchdog to protect their interests. This is so because creditors were not represented at the general meeting which passed the resolution authorizing the company to issue the shares at a discount and so the court steps in to protect their interests. If the issue of shares at a discount would adversely affect any creditor, the court would probably not sanction the issue.

f) The issue is made within one month after the court's sanction.

This provision acknowledges the fact that the stock exchange market is a highly fluid market. If a company's members pass a resolution authorizing an issue at a discount because of the prevailing market conditions the directors must act on the resolution before the market conditions change. The statutory assumption appears to be that the market conditions would have materially changed within one month after the court's confirmation. If the directors were to issue the shares at a discount despite the changed conditions, the issue could not be justified.

Another general meeting should be held to enable the members to reconsider their decision in the context of the changed conditions. However, the directors may ask the court to extend the time for issuing the shares at the prescribed discount if they are of the view, and the court concurs, that the market conditions have not materially changed. The flaw with this provision is that it does not provide a time limit for applying to the court for its sanction.

2 Payment of Underwriting Commission

A "commission" is defined by Osborn's Concise Law Dictionary as, inter alia "an agent's remuneration". For purposes of company law, it denotes the amount of money paid by a company to a person "in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company"

Section 55 (1) of the Act allows a company to pay the commission if:-

- a) the payment is authorized by the company's articles; and
- b) the commission paid or agreed to be paid does not exceed 10% of the price at which the shares are issued or the amount or rate authorized by the articles, whichever is the less; and
- c) the amount or rate per cent of the commission paid or agreed to be paid is -
 - i) in the case of shares offered to the public for subscription, disclosed in

the prospectus; or

- ii) in the case of shares not offered to the public for subscription, disclosed in the statement in lieu of prospectus, or in Form No.225 signed by all the directors or their agents authorized in writing; and
- d) the number of shares which it has been agreed to subscribe absolutely is disclosed in manner aforesaid.

Section 55 (2) provides that, except as provided by subsection (1), no company shall apply any of its shares or capital money, either directly or indirectly, in payment of any commission, discount or allowance to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, or procuring or agreeing to procure subscriptions, absolute or conditional, for any shares in the company, whether the shares or money be applied by being added to the purchase money of any property acquired by the company or to the contract price of any work to be executed for the company, or the money be paid out of the nominal purchase money or contract price, or otherwise.

In Andreae V Zinc Mines of Great Britain Ltd (45) it was explained that any agreement to pay commission in contravention of S.55 is null and void.

The effect of payment of underwriting commission is that the company's shares will have been issued at a discount. S.55 is therefore intended to provide some measure of statutory control over a company's power to pay commission.

3 Brokerage

Brokerage is a payment made by a company to a broker, or brokers, in consideration for "placing" the company's shares. It differs from underwriting commission in that it is a payment made to an agent who is selling the company's shares on its behalf without undertaking to buy the shares which he fails to sell. In Andreae V Zinc Mines of Great Britain Ltd (45) Bailhache, J. explained that a payment is brokerage only if it is made to "stockbrokers, bankers and the like, who exhibit prospectuses and send them to their customers, and by whose mediation the customers are induced to subscribe". Consequently, a payment which was made to a lady of a percentage on the amount of capital which she induced third parties to subscribe for shares in the defendant company was held not to be brokerage. The lady could not be regarded as a "broker" on the basis of such an isolated transaction. The person to whom the payment is made must be one who carries on the business of a broker, either exclusively or as part of his general business, as in the case of a banker.

Subsection (3) provides that nothing in Section 55 "shall affect the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay". It was previously held in Metropolitan Coal Consumers' Association V Scrimgeour (1895) that brokerage of a reasonable amount paid by a company in the ordinary course of its business was legal. In that case the brokerage was 2 1/2%. The usual brokerage varies between 1/4% - 1/2%. The reasonableness of the commission does not depend on mere percentages but on what it would cost the company to sell the shares by itself. If, by paying the brokerage, the company would spend less money in selling the shares then the payment would be regarded as a reasonable one. Although the payment of brokerage is a derivation from mercantile usage it is usual for companies to incorporate in their articles a clause which expressly

authorises the company to pay brokerage. For example, Article 6 of Table A provides that "the company may also on any issue of shares pay such brokerage as may be lawful".

Although payment of brokerage means that the company will ultimately receive less money for the shares it has issued the payment is not prohibited by the Act. It is essentially an expense which is incidental to the issue of the shares and a company cannot avoid incurring such an expense.

2.2.1 PROVISIONS WHICH PREVENT CAPITAL GOING OUT OF THE COMPANY

In Trevor v Whitworth (1887) Lord Watson stated:

"Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent, but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at a call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business".

As Lord Watson acknowledged, no legislation can prevent a company's capital from being lost or diminished in the course of the company's business. However, various provisions of the Companies Act, and case law, are intended to ensure that no part of the company's paid-up capital is paid out by the company except in the legitimate course of its business. They are:

i) SHARES ISSUED AT A PREMIUM

A company may at times issue its shares at a price above their nominal value, i.e at a premium. This may be necessitated by the fact that the company's shares which have already been issued are being sold in the open market at a price which is above their nominal value. Since such an issue does not jeopardize the position of the company's creditors there is no legal requirement that the issue be confirmed by the court. However, Section 58 (1) provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account called "the share premium account". The section further provides that the share premium account shall be governed by the provisions of the Companies Act relating to the reduction of the share capital of a company as if the share premium account were paid share capital of the company. This means, in effect, that the funds credited to the share premium account are not paid out by the company except in the legitimate course of its business.

Sub-section 2 provides that the share premium account may however be applied by the company:

- a) To pay up unissued shares of the company which are to be issued to members of the company as fully-paid bonus shares;
- b) To write off the preliminary expenses of the company;
- c) To write off the expenses of any issue of shares or debentures of the company, or the commission paid or discount allowed on such issue, or

- d) To provide for the premium payable on redemption of any redeemable preference shares or debentures of the company.

MERGER ACCOUNTING

It may happen that, during a "take-over" of one company (A) by another company (B), shares in the latter company are issued to shareholders of the former company in exchange. Company A would then be dissolved and Company B would acquire its shares. Should a share premium account be established by company B when the assets of Company A exceed the nominal value of Company A's shares? If a share premium account is opened the pre-acquisition profits of Company A would not be distributed by Company B. It may therefore be decided that no share premium account is to be opened. This method of accounting is known as "merger accounting".

ACQUISITION ACCOUNTING AND "MERGER RELIEF"

In SHEARER V BERCAIN (1980) it was held that "merger accounting" is illegal and that a "true value" must be attributed to the non-cash assets acquired and the excess of the "true value" over the nominal value of the shares must be transferred to a share premium account. This method of accounting is known as "acquisition accounting" and means that the pre-acquisition profits of Company A cannot be distributed by Company B. It is yet unclear as to whether Kenya courts will adopt the decision in Shearer v Bercaín. The Kenya Companies Act does not provide "merger relief" that was introduced by the English Companies Act of 1981.

ii) PURCHASE OF OWN SHARES

Another possible way in which a company's paid-up capital may leave the company other than in the ordinary course of the company's business would be if the company purchased its own shares. It was therefore held in Trevor v Whitworth (48) that it is illegal for a limited company to purchase its own shares. Such a purchase, if permitted, would constitute an indirect reduction of the paid-up capital without compliance with the statutory provisions relating to reduction of capital. This is the general rule that is applicable in Kenya. This decision was said to be based on the implied provisions of the English Companies Act 1862. The said provisions were incorporated in the English Companies Act 1948 which in turn became our Companies Act (Cap. 486). It may however be criticized for its assumption that whenever a company buys its shares it would do so by utilizing its paid-up capital. It is in fact possible for a company to buy its shares without using its paid-up capital but using the money from a reserve fund which was constituted for that purpose. Such a purchase might in fact be beneficial to the company which could use it as a mechanism for propping up the market value of its shares at a time when there is panic selling by its shareholders which has been precipitated by adverse rumours about the company. The company would later resell the shares in such a way as to prevent high fluctuations in their market prices.

Despite the rule in Trevor V Whitworth a company may purchase or acquire its own shares in the following cases:

- a) Where it acquires its own fully paid shares otherwise than for valuable consideration, as in Re: Castiglione's Will Trusts (49),

- b) Where it is a purchase of redeemable shares under S.60 of the Act. This is permitted because the redemption "shall not be taken as reducing the amount of the company's authorized share capital" if it is done in accordance with the provisions of the section.
- c) Where the shares are acquired pursuant to the resolution for reducing the company's capital under S.68 of the Act. Such acquisition is permitted because the interests of the company's creditors would have been protected by the court at the time of confirming the proposed reduction.
- d) Where the shares are purchased in pursuance of a court order under S.211 (2) on an application by the oppressed members. The shares purchased would be cancelled and the company's capital reduced accordingly.
- e) Where the shares are forfeited for non-payment of a call, or where they are surrendered in lieu of a forfeiture.

iii) FINANCIAL ASSISTANCE FOR PURCHASE OF OWN SHARES

S.56 (1) of the Act renders it unlawful for a company to give, whether directly or indirectly and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company, or, where the company is a subsidiary company, in its holding company. The consequences of a contravention of the section are:

- a) The contract for the financial assistance is void and illegal, and cannot be enforced against a party thereto: Standard Bank v Mehoto Farm (50);
- b) The company and every officer of the company who is in default shall be liable to a fine not exceeding twenty thousand shillings;
- c) Every director who is a party to the contravention is guilty of a breach of trust and is liable to recoup any losses which the company suffers as a result: Wallersteiner v Moir (51)

Exceptions

S.56 (1) permits a company to give financial assistance for a purchase of, or subscription for, its shares in the following circumstances:

- a) Where the lending of money is part of the ordinary business of the company and the money is lent by the company in the ordinary course of its business. In Steen v Law (52) the Privy Council explained that this provision does not validate a loan given for the express purpose of enabling the loanee to purchase the lending company's shares. This is so because no company can be constituted for the sole purpose of lending money to persons who would be buying its shares so that a loan it gives for any other purpose would be regarded as an "unusual" or

"extraordinary", loan. To be valid, therefore, the loan must have been given for one of the purpose for which the company ordinarily or usually lends money but was diverted (wholly or partly) to a purchase of the lending company's shares.

- b) Where the loan is to trustees to enable them to purchase fully paid shares in the company to be held under an employees' share scheme.
- c) Where the loan is to employees' (other than directors) to enable them to purchase or subscribe for fully-paid shares in the company or its holding company to be held by themselves by way of beneficial ownership. If a company gives a loan to an employee to purchase shares in the company the employee must have the shares registered in his own name and not the name of a spouse or child. This is intended to induce the employee to be more motivated and productive by ensuring that he personally and directly reaps the fruits of his increased productivity.

3. ALTERATION OF CAPITAL

A company is empowered by S.63 to alter the provisions of its memorandum of association which relates to its registered or authorised capital. However, the power is exercisable subject to the following conditions:

- a) The articles must confer the authority to alter the capital. If they do not, they may be altered by special resolution and the authority incorporated therein.
- b) The company must hold a general meeting for the purpose of altering the capital.
- c) The alteration must be authorised by an ordinary resolution (See Table A, Article 45).

3.1 MODE OF ALTERATION

The alteration of capital may be made by -

- 1) Increasing the company's share capital by new shares of such amount as the resolution prescribes; or
- 2) Consolidating and dividing all or any of the company's share capital into shares of larger amount than the existing shares; or
- 3) Converting all or any of the company's paid-up shares into stock, or reconverting the stock into paid-up shares of any denomination; or
- 4) Subdividing all or any of the shares into shares of smaller amount than is fixed by the memorandum; or
- 5) Canceling shares which have not been taken or agreed to be taken by any person, and diminish the amount of the capital. This mode of alteration is also known as diminution of capital. Subsection (3) provides that it shall not be deemed to be a reduction of share capital within the meaning of the Act.

- 3.2 The registrar must be notified of an alteration of capital within thirty days after the passing of the resolution authorizing the alteration. In the event of a failure to do so, the company and every

officer of the company who is in default shall be liable to a default fine.

4. REDUCTION OF CAPITAL

4.1 The general rule is that it is illegal for a company to reduce its capital. This is so because such a reduction would be tantamount to reducing the security available to the company's creditors: Trevor v Whitworth (48). However, S.68 (1) authorizes a company to reduce its capital if:

- a) The company's articles authorizes it to do so. If the articles do not confer the authority they can be amended by the inclusion therein of the requisite authority.
- b) The company passes a special resolution to that effect. The resolution is defined by S.68 (2) as "a resolution for reducing share capital".
- c) The court confirms the proposed reduction. The court's confirmation is required in order to protect the interests of the company's creditors, minority members and the general public, as explained below.

4.2 MODE OF REDUCTION

S.68 (1) expressly states that a company may reduce its capital "in any way". There is therefore no statutorily prescribed mode of reduction and the actual scheme adopted by the company will depend on the ingenuity of its directors or accountants. However, the Act gives the company an option of reducing its capital in one of the following ways:

- a. By extinguishing the liability on any of its shares in respect of Share Capital not paid up: S.68 (1) (a)

Example:

The company's memorandum reads:

"... 1,000,000/- divided into 100,000 Ordinary Shares of 10/- each."

- amount already paid per share is shs.5/-
- amount unpaid per share is shs.5/-

The company passes a special resolution to reduce the capital to shs.500,000/-. The resolution is confirmed by the court.

The amended memorandum will read as follows:

"... 500,000/- divided into 100,000/- Ordinary Shares of 5/- each."

- amount already paid per share is shs.5/-
- the unpaid amount of 5/- per share ceases to be payable and the liability thereon is "extinguished."

- b. By reducing the liability on any of its shares in respect of share capital not paid up: S.68 (1) (a)

Example:

The company's memorandum reads:

"... 1,000,000/- divided into 100,000/- Ordinary Shares of 10/- each."

- amount already paid per shares is shs.5/-.
- amount unpaid per share is shs.5/-.

The company passes a special resolution to reduce the capital to shs.750,000/-. The resolution is confirmed by the court.

The amended memorandum will read as follows:

"... 750,000/- divided into 100,000 Ordinary Shares of shs.7/50 each."

- amount already paid per share is shs.5/-.
- amount unpaid per share becomes shs.2/50 (i.e. the liability on unpaid shares has been reduced from shs.5/- to shs.2/50).

- c. By canceling any paid-up share capital which is lost or unrepresented by available assets without extinguishing or reducing liability on any shares: S.68 (1) (b):

Example:

The company's memorandum reads:

"... 1,000,000/- divided into 100,000 Ordinary Shares of 10/- each.."

- amount already paid per share is shs.5/-
- amount unpaid on each share is shs.5/-

The Shs.500,000/- received from the shareholders was banked by the company. Shs.100,000/- was later withdrawn from the bank and used to buy goods for resale. After the goods were paid for and received, they were kept in the company's store pending delivery to customers the following day. The directors felt that it was unnecessary to insure the goods for one night only. A fire completely destroyed the good during the night. The shs.100,000/- used to buy the goods represents the capital which, according to the Act, "is lost or unrepresented by available assets."

The company passes a special to reduce its capital by shs.100,000/-. The resolution is confirmed by the court.

The amended memorandum will read:

"...900,000/- divided into 100,000 Ordinary Shares of 9/- each."

- amount unpaid on each share is shs.5/- (i.e. the liability on unpaid shares has not been reduced or extinguished).
- amount paid per share becomes 4/- (by consent of shareholders).

This mode of reduction is legally possible but may be questioned from a practical point of view. The truth is that it is the shareholders who have in fact lost their capital.

It should be noted that, despite the above reduction, the members will receive the same amount of dividend from the company as they would have received if, for psychological reasons, the directors did not ask them to reduce the capital so that the shares retained their 10/- nominal value.

- d. By canceling any paid up share capital which is lost or unrepresented by available assets and also reducing liability on any shares: S.68 (1) (b).

Example:

The company's memorandum reads:

"...1,000,000/- divided into 100,000 Ordinary Shares of 10/- each."

- amount already paid per share is shs.5/-
- amount unpaid per share is shs.5/-

Assume that the same type and quantity of goods are destroyed by fire in the same circumstances as in example (c) above.

The company passes a special resolution to reduce its capital by shs.200,000/-. The resolution is confirmed by the court.

The amended memorandum will read:

"...800,000/- divided into 100,000 Ordinary Shares of 8/- each."

- amount already paid per share is shs.5/-
- amount unpaid per share becomes shs.3/-.

- e. By cancelling any paid-up share capital which is lost or unrepresented by available assets and also extinguishing liability on any shares: S.68 (1) (b)

Example:

The company's memorandum reads:

"...1,000,000/- divided into 100,000/- Ordinary Shares of 10/- each."

- amount paid per share is 9/-.
- amount unpaid per share is 1/-.

The shs.900,000/- received by the company from the shareholders is banked. Shs.100,000/- is later withdrawn to buy goods for resale.

The goods are destroyed by fire in circumstance identical with those in example (c) above.

The company can reduce its capital by shs.200,000/- so that the amended memorandum will read as follows:

"...800,000/- divided into 100,000/- Ordinary Shares of 8/- each."

- amount paid per share becomes 8/-
- amount unpaid per share is NIL (i.e. the liability of 1/- has been extinguished).

- f. By paying off paid-up share capital which is in excess of the wants of the company without extinguishing or reducing liability on any shares

Examples:

- i) The company's memorandum reads:

"...10,000,000/- divided into 1,000,000 Ordinary Shares of Shs.10/- each."

- 5/- has been paid on each share
- 5/- is unpaid on each share

The company can pass a special resolution to reduce the capital to 7,500,000/- by paying back to the shareholders shs.2,500,000/- out of the shs.5,000,000/- they have already paid to the company if the directors convince the members that the paid-up amount of shs.5,000,000/- is in excess of the company's current needs and it will take a long time before the company would require more capital.

The company's memorandum will be amended to read:

"...Shs.7,500,000/- divided into 1,000,000 Ordinary Shares of 7/50 each."

- amount paid on each share becomes shs.2/50;
- amount unpaid on each share remains shs.5/-.

- ii) Study the scheme adopted by the British and American Trustee & Finance Corporation Ltd.

- g. By paying off paid-up capital which is in excess of the company's needs by extinguishing liability on any shares.

Example:

Read the scheme of reduction that was adopted by the British and American Trustee and Finance Corporation Ltd. and confirmed by the House of Lords.

- h. By paying off paid-up capital which is in excess of the company's needs and reducing liability on any shares

Example:

A company's authorised and issued capital is 10,000,000/- divided into 1,000,000 Ordinary Shares of 10/- each. Shs.5/- has been paid on each share.

The company can pass a special resolution to reduce the capital to 5,000,000/- by paying to the shareholders shs.21/2m/- out of the 5m/- which they have already paid to the company if the directors tell the members that the paid up amount of shs.5m/- is in excess of the company's current needs.

The company's amended memorandum will read as follows:

"...5,000,000 divided into 1,000,000 Ordinary Shares of shs.5/- each." Amount paid on each share becomes 2/50 and the unpaid amount of 5/- is reduced to 2/50.

4.3 THE FUNCTION OF THE COURT

In Scottish Insurance Corporation Ltd v. Wilsons & Clyde Coal Co. Lord Simmons stated:

"But important though its task is to see that the procedure by which a reduction of capital is carried through is formally correct and that creditors are not prejudiced, it has the further duty of satisfying itself that the scheme is fair and equitable between the different classes of shareholders". The court would therefore, not confirm a scheme of reduction if it is of the view that it is not "fair and equitable" to any of shareholders.

a) PROTECTION OF CREDITORS

Where the reduction of capital involves diminution of unpaid capital or repayment to shareholders of paid-up capital, creditors have a statutory right under S.69(2) to object to the proposed reduction and, upon objection, a list of creditors must be given to the court. The court will then confirm the reduction if satisfied that the creditors:

- i) have consented thereto; or,
- ii) have been secured (i.e. given alternative security so that they will no longer rely on the reduced capital as their security), or
- iii) have been discharged or paid off (S.70 (1)).

b) PROTECTION OF MEMBERS

- 1. A majority of the company's members are protected by the requirement that a special resolution must be passed by the company's members in order to initiate the reduction process. It is most unlikely that a three-fourths majority of members could freely pass a resolution for reducing capital if the resolution is detrimental to their

interests.

2. A minority of the company's members are protected by their judicially acknowledged right to seek the court's protection where they are of the view that the resolution passed by the majority is not "fair and equitable": British and American Trustee and Finance Corporation Ltd, and Reduced V Couper (53) and Re: Thomas de la Rue and Co. Ltd and Reduced (55),

c) PROTECTION OF GENERAL PUBLIC

It may happen that a resolution reducing a company's capital was passed in circumstances which indicate that the shareholders had not been properly and correctly informed about the real causes of the reduction. In such a case, it is desirable that the general public, as potential members of the company, should be told the truth about the reduction. Section 70 (2) (b) empowers the court where appropriate, to make an order requiring the company to publish, as the court directs, the reason for reduction or such other information in regard thereto as the court may think expedient with a view to giving proper information to the public, and, if the court thinks fit, the causes which led to the reduction.

The court order confirming the reduction and the relevant minute as approved by the court, must be delivered to the registrar for registration. S71 (2) provides that, on the registration of the order and minute, and not before, the resolution for reducing share capital as confirmed by the order so registered shall take effect.

4.4 LIABILITY OF MEMBERS

S.72 (1) provides that in the case of a reduction of share capital a member of the company, past or present, shall not be liable in respect of any share to any call or contribution exceeding in amount the difference, if any, between the amount of the share as fixed by the minute and the amount paid, or the reduced amount, if any, which is deemed to have been paid on the shares.

5 REDEMPTION OF SHARES

Section 60 (1) empowers a company limited by shares to issue preference shares which are, or at the option of the company are to be liable, to be redeemed, if the articles authorise such an issue. It however, provides that –

- a) no such shares shall be redeemed except 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 purposes of the redemption;
- b) no such shares shall be redeemed unless they are fully paid;
- c) the premium, if any, payable on redemption must have been provided for out of the profits of the company or out of the company's share premium account before the shares are redeemed;
- d) where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend be transferred to a reserved fund, to be called the capital redemption reserve fund, a sum equal to the nominal amount of the shares redeemed. The provisions of the Act relating to the reduction of the share capital of a company shall apply to the reserve fund as if it were paid-up share capital of the company, but subsection 5 provides that the capital redemption reserve fund may be applied by the company in paying up unissued shares of the company

to be issued to members of the company as fully paid bonus shares. These provisions are intended to prevent a company's authorised capital from being reduced by any redemption of the redeemable preference shares of the company.

6 DIVIDENDS

As a commercial term, the word "dividends" has a variable meaning which depends on the context in which it is used. For purposes of company law, it denotes the payments which a company makes out of its profits to the shareholders in the company.

6.1 BASIC RULE

The basic rule is that "dividends must not be paid out of capital": Verner v General & Commercial Investment Trust (per Lindley, J). For purposes of this rule "Capital" means the money subscribed pursuant to the memorandum of association, or what represents that money: Verner v General & Commercial Investment Trust.

6.2 DECLARATION AND PAYMENT

There is no provision in the Act dealing with payment of dividends. It is therefore governed by the provisions of the company's articles, failing which the provisions of Table A which are as follows:

i) Article 114

The company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the directors. The use of the word "may" means that the company in general meeting is not bound to declare dividends even if the directors have recommended a particular amount. On the other hand, no dividend can be declared if the directors have recommended none.

ii) Article 115

The directors may from time to time pay to the members such interim dividends as appear to the directors to be justified by the profits of the company. A resolution passed at a general meeting directing the directors to pay interim dividends is invalid. Scott v Scott (56)

iii) Article 116

No dividend shall be paid otherwise than out of profits. In Verner v General & Commercial Investment Trust Lindley, J expressed the view that, because the word "profits" is somewhat ambiguous, this provision should be understood to mean that "dividends must not be paid out of capital". Provided the dividend is not paid out of capital, it does not matter from whatever fund it is paid, whether called profits or otherwise.

iv) Article 118

Subject to the rights of persons, if any, entitled to shares with special rights as to dividend, all dividends shall be declared and paid according to the amounts paid or credited as paid on the shares in respect whereof the dividend is paid. This provision modifies the common law rule that dividends are paid on the nominal value of the shares: Oak Bank Co. v Cram.

v) Article 120

Any general meeting declaring a dividend may direct payment of such dividend wholly or partly by the distribution of specific assets and in particular of paid-up shares, debentures or any one or more of such ways. This article gives the company power to pay dividend in kind. In the absence of such a provision, dividend is payable in cash and the company may be restrained from paying it in any other form: Wood v Odessa Waterworks Co. (57)

vi) Article 121

Any dividend, interest or other moneys payable in cash in respect of shares may be paid by cheque or warrant sent through the post directed to the registered address of the holder or, in the case of joint holders, to the registered address of that one of the joint holders who is first named on the register of members or to such person and to such address as the holder or joint holders may in writing direct. Every such cheque or warrant shall be made payable to the order of the person to whom it is sent.

This provision gives the company express authority to remit the dividend cheque or warrant by post. If the dividend cheque or warrant is lost in transit the loss prima facie falls on the shareholder. In the absence of such a provision the company would have no authority to remit the dividends by post and, if it does and the dividend cheque is lost in transit, it must issue a fresh cheque to the shareholder: Thairlwall v Great Northern Rly.

vii) Article 122

No dividend shall bear interest against the company. At common law the declaration of a dividend creates a simple contract debt due from the company to the shareholder which will be time-barred in six years from the date of declaration.

6.3 CASE LAW RELATING TO DIVIDENDS

The above provisions of Table A supplement the following common law rules:

- 1) Losses in previous years need not be provided for. A dividend can be paid if there is a profit on the current year's trading: Re: National Bank of Wales (1899).
- 2) Profits of previous years can be brought forward and distributed even if there is a revenue loss in the current trading year: Re: Hoare & Co (1904)
- 3) Losses on fixed assets in the current year need not be made good by provision for depreciation before treating a revenue profit as available for dividend: Lee v Neuchatel Asphalte Co (1889)
- 4) Unrealized capital profits on a revaluation of assets can be distributed by way of a dividend, or used to pay a bonus issue of fully paid shares: Dimbula Valley (Ceylon) Tea Co v Laurie (1961).
- 5) Dividends must not be paid out of capital: Verner v General & Commercial Investment Trust.

REINFORCING QUESTIONS

1. Your clients, a group of twenty farmers, wish to incorporate themselves as a company limited by shares. The company's main object will be growing and exporting of horticultural crops. They seek your advice on the following:
 - a) What problems, if any, they will encounter if they should wish to bring further members into the company; *(5 marks)*
 - b) Whether it will be possible to prevent a member from selling his shares to an outsider without the consent of the rest of the groups; *(5 marks)*
 - c) The extent to which the company's finances and membership must become public knowledge; *(5 marks)*
 - d) Whether it will be possible for an outsider to sue a member for recovery of money owed to him by the company; *(5 marks)*
2. "Mwangi has been induced to buy shares in the Makaa Co. Ltd on the faith of a statement in a prospectus that is untrue. What remedies are available to Mwangi against:
 - (a) Makaa Co. Ltd;
 - (b) the directors and promoters of the company?

COMPREHENSIVE ASSIGNMENT No.1

TO BE SUBMITTED AFTER LESSON 2

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

EXAMINATION PAPER. TIME ALLOWED: THREE HOURS. ANSWER ALL QUESTIONS

1. "The company is at law a different person altogether from the subscribers to the memorandum of association" (per Lord Macnaghten in Salomon v Salomon Co. Ltd.).

Discuss this statement by reference to decided cases.

2. What are the advantages, from a legal point of view, of converting a partnership business into a company limited by shares?
3. Explain the provisions of the Companies Act which constitute "lifting the veil of incorporation".
4. Explain the circumstances in which a company may:
 - a. give financial assistance for a purchase of shares, and
 - b. issue its shares at a discount.
5. Explain the legal rules relating to payment of company dividends.

To what extent may the legal rules be made to conform to accounting practice?

END OF COMPREHENSIVE ASSIGNMENT No.1

NOW SEND YOUR ASSIGNMENT TO STRATHMORE UNIVERSITY DISTANCE LEARNING CENTRE FOR MARKING