editorial

Should Companies Purchase their own Shares

On July 1 the Secretary of State for Trade, John Nott, unveiled the first fruits of the appointment of Professor L C B Gower as the Research Adviser on company law to the Department of Trade – the Green Paper *The Purchase by a Company of its own Shares* (Cmnd 7944, HMSO, £2.25; see also p 221, post).

The present law (as now codified by Companies Act 1980, s 35) is clear that, subject to narrowly drawn exceptions, limited companies may not acquire their own shares.

As regards private companies, to quote Mr Nott's words, "liberalisation of the law is likely to encourage expansion, risk-taking and venture capitalism in the firms which are our seed-corn for the future".

Professor Gower sets out in Part II of the Paper a number of possible approaches including permitting private companies to issue redeemable equity shares by suitably amending s 58 of the Companies Act 1948 (which presently permits only the issue of redeemable *preference* shares). On this basis shares could only be redeemed or purchased out of the proceeds of a new share issue or out of profits. A more radical alternative offered in the paper would be to permit shares to be redeemed out of capital – in essence this would amount to a simplified form of reduction of capital not needing the sanction of the court but giving shareholders and creditors the right to petition the court to prohibit the reduction.

We have doubts at a practical level as to the value of the proposals for private companies. Their aims can already largely be met by issuing to the investor a mixture of equity shares and loan capital (which can be convertible if desired). The proportion of the investment which is in share form can be quite small – and will be irredeemable but will share in capital and revenue profits. The bulk of the investment would then be in redeemable loan form. This has a number of incidental advantages: loan interest (unlike dividends) is a tax deductible expense for the company, no capital duty is payable on issue and the drawbacks to the repayment of "first business loans" by close companies have now been effectively abrogated. This approach is also logical by structuring redeemable capital expressly in loan form – creditors could be given further comfort by suitable contractual provisions subordinating repayment of the loan capital to the claims of trade creditors. There would be one disadvantage, of very recent origin. Under the new Finance Act losses on equity share investments in private companies are allowable as deductions from income; losses on loan capital remain only allowable against capital gains. We therefore wonder whether the problem here may be more that professional advisers are not using sufficient imagination in relation to small business capital structures under the existing law.

Turning to listed public companies the Government's concern is that these companies should be able to return surplus resources to shareholders to avoid their "uneconomic use". This desire may be related to the current scepticism as to the value of many mergers and acquisitions particularly where the acquiring company is a "conglomerate" – the Government is in sympathy with the "agnostic" views of the Liesner Report (1978, Cmnd 7198; See p 238, post). Here there are even greater technical problems than in the case of private companies (eg the provisions of the EEC 2nd company law directive).

For both public and private companies a major obstacle to the proposals lies in the present tax rules – any excess received by a shareholder over his original investment is treated as an income distribution. However, a tentative start has been made with the provisions on "demergers" in the 1980 Finance Act. Mr Nott's aim is clearly to set the pace with company law reforms, leaving the Treasury to catch up with their own fiscal reforms later.