

Principles of Corporate
Finance Law

EILÍS FERRAN

OXFORD
UNIVERSITY PRESS

Principles of Corporate Finance Law

EILÍS FERRAN

OXFORD
UNIVERSITY PRESS

OXFORD

UNIVERSITY PRESS

Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide in

Oxford New York

Auckland Cape Town Dar es Salaam Hong Kong Karachi
Kuala Lumpur Madrid Melbourne Mexico City Nairobi
New Delhi Shanghai Taipei Toronto

With offices in

Argentina Austria Brazil Chile Czech Republic France Greece
Guatemala Hungary Italy Japan Poland Portugal Singapore
South Korea Switzerland Thailand Turkey Ukraine Vietnam

Oxford is a registered trade mark of Oxford University Press
in the UK and in certain other countries

Published in the United States
by Oxford University Press Inc., New York

© Eilís Ferran, 2008

The moral rights of the author have been asserted

Crown copyright material is reproduced under Class Licence
Number C01P0000148 with the permission of OPSI
and the Queen's Printer for Scotland

Database right Oxford University Press (maker)

First published 2008

All rights reserved. No part of this publication may be reproduced,
stored in a retrieval system, or transmitted, in any form or by any means,
without the prior permission in writing of Oxford University Press,
or as expressly permitted by law, or under terms agreed with the appropriate
reprographics rights organization. Enquiries concerning reproduction
outside the scope of the above should be sent to the Rights Department,
Oxford University Press, at the address above

You must not circulate this book in any other binding or cover
and you must impose the same condition on any acquirer

British Library Cataloguing in Publication Data
Data available

Library of Congress Cataloguing in Publication Data
Data available

Typeset by Newgen Imaging Systems (P) Ltd., Chennai, India
Printed in Great Britain

on acid-free paper by
CPI Antony Rowe, Chippenham, Wiltshire

ISBN 978-0-19-923050-1 (Hbk.)

ISBN 978-0-19-923051-8 (Pbk.)

1 3 5 7 9 10 8 6 4 2

PRINCIPLES OF CORPORATE
FINANCE LAW

This book is dedicated to my mother, Kay Ferran, and
to the memory of my father, Gerry Ferran

Preface

This book is derived from *Company Law and Corporate Finance*, which was published in 1999. The book has been reoriented to concentrate on the parts of company law that are most directly relevant to the financing of the corporate sector and to include more securities regulation relating to corporate issuers' access to the public markets. The law in these areas has developed significantly since 1999 and I have sought to explain the changes, explore their underlying aims, and assess their overall significance.

Although the book is about British law, the regulatory agenda relating to corporate finance is increasingly set at the EU level. This trend, which was certainly evident in 1999 but which has increased dramatically since then, is reflected in the text. I have benefited greatly from a rich and growing body of literature on EC corporate and securities law by European scholars, and from comparative scholarship by researchers from other parts of the world. Luca Enriques, Howell Jackson, and Niamh Moloney merit special mention for their willingness to read working papers in which some of the ideas that made their way into this book were first expressed and to give invariably incisive, yet constructive, criticism.

The challenges involved in following the many twists and turns that arose in the reform process leading up to the UK Companies Act 2006 and in coming to terms with that colossal instrument were made easier by having friends and colleagues with whom to discuss its more mystifying aspects. This group includes John Armour, Martina Asmar, Philip Bovey, Kathryn Cearn, Brian Cheffins, Paul Davies, James Palmer, Caroline Quinnell, Jonathan Rickford, Pippa Rogerson, Carol Shut Kerer and, especially, Richard Nolan, whose trenchant views never fail to stimulate. I am grateful also to the partners of Herbert Smith for enabling me to keep in touch with changes in practice.

I was privileged to be able to share ideas and draft chapters with groups of LLM students at Cambridge University, particularly the 2006–07 and 2007–08 year groups. Their feedback helped to clarify my thinking on numerous points. I also learnt a lot from my two former research students, Dr Thomas Bachner and Dr John Vella. I would also like to thank the OUP commissioning and production team, in particular John Louth, Gwen Booth, Bethan Cousins, and Alison Floyd.

My father and a close friend both died a few weeks before I completed the manuscript. Those sad events and the gatherings of family and friends that followed them affected me deeply and reminded that even though I am lucky enough to have an enriching and fulfilling job, it is only one part of life and not

the most fundamentally important aspect. My husband, Rod, and my two children, Aoife and Oliver, are at the centre of my life and I am profoundly grateful to them for all that they do.

Eilís Ferran

St Catharine's College, Cambridge
,17 December 2007

List of Abbreviations

General

ABI	Association of British Insurers
AIM	Alternative Investment Market (London Stock Exchange)
ASB	Accounting Standards Board
ASBJ	Accounting Standards Board of Japan
BERR	Department for Business, Enterprise and Regulatory Reform
BIS	Bank for International Settlements
BVA	base value of assets
BVL	base value of liabilities
CAPM	Capital Asset Pricing Model
CARD	Consolidated Admission and Reporting Directive
CESR	Committee of European Securities Regulators
DTI	Department of Trade and Industry (now the BERR, see above)
<i>DTR</i>	<i>FSA Disclosure Rules and Transparency Rules</i>
EC	European Community
ECB	European Central Bank
ECJ	European Court of Justice
EEA	European Economic Area
ESME	European Securities Market Expert Group
FASB	Financial Accounting Standards Board (US)
FEE	Federation of European Accountants
FMLC	Financial Markets Law Committee
FRS	Financial Reporting Standards
FSA	Financial Services Authority
FSAP	Financial Services Action Plan (European Commission)
FSMA 2000	Financial Services and Markets Act 2000
GAAP	Generally Accepted Accounting Principles
HMT	Her Majesty's Treasury
IAS	International Accounting Standards (now IFRS, see below)
IASB	International Accounting Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
ICAS	Institute of Chartered Accountants of Scotland
IDS	International Disclosure Standards
IFRS	International Financial Reporting Standards
IMA	Investment Management Association
IOSCO	International Organization of Securities Commissions
IPO	initial public offer
LIBOR	London Inter-Bank Offered Rate
<i>LR</i>	<i>FSA Listing Rules</i>
MiFID	Markets in Financial Instruments Directive
MJDS	Multi-jurisdictional Disclosure System (between the US and Canada)

MM theorem	Modigliani-Miller theorem
NAPF	National Association of Pension Funds
NASDAQ	National Association of Securities Dealers Automated Quotations
Nomad	nominated adviser (under AIM <i>Rules for Companies</i>)
NYSE	New York Stock Exchange
PAL	provisional allotment letter
<i>PR.</i>	<i>FSA Prospectus Rules</i>
PSM	Professional Securities Market
QIB	qualified institutional buyers
RIE	recognized investment exchange
RIS	Regulatory Information Service
SEC	Securities and Exchange Commission (US)
SIMEX	Singapore International Monetary Exchange
SLIM project	Simpler Legislation for the Internal Market project (European Commission)
SMEs	small and medium-sized enterprises
SPEs	special purpose entities
SPVs	special purpose vehicles
SUSMI	substantial US market interest
TIFFE	Tokyo International Financial Futures Exchange
TRACE	Trade Reporting and Compliance Engine
UKLA	United Kingdom Listing Authority
WACC	weighted average cost of capital

Publications

ALJ	Australian Law Journal
CFILR	Company Financial and Insolvency Law Review
CLJ	Cambridge Law Journal
Conv	The Conveyancer and Property Lawyer
JBL	Journal of Business Law
LMCLQ	Lloyd's Maritime and Commercial Law Quarterly
LQR	Law Quarterly Review
MLR	Modern Law Review
NLJ	New Law Journal
NZLJ	New Zealand Law Journal
OJLS	Oxford Journal of Legal Studies

Contents

<i>List of Abbreviations</i>	xxii
<i>Table of Cases</i>	xxv
<i>Table of Legislation</i>	xli
<i>Note on the Implementation of the Companies Act 2006</i>	li

I. OVERVIEW

1. The Regulatory Framework	3
Scope of the book	3
Types of company limited by shares	4
The regulatory framework for corporate finance	7
Legislation	8
Internal constitutional instruments	9
Case law	10
Codes and guidelines	11
2. Use and Abuse of the Corporate Form as a Vehicle for Raising Finance and Managing Financial Risk	13
Issues considered in this chapter	13
Distinctive features of the company limited by shares	14
Separate legal personality	14
<i>Lifting the veil of incorporation</i>	16
Limited liability	18
<i>Promotion of entrepreneurial activity</i>	20
<i>Passive investment</i>	20
<i>Portfolio diversification</i>	21
<i>Cost of capital</i>	22
<i>Transferability of shares</i>	24
<i>Tort liabilities</i>	24
The corporate group	25
The definition of the corporate group for accounting purposes	27
The definition of the corporate group for other purposes	30
Company law and the corporate group: a general overview	31
The corporate group and liability for the debts of insolvent subsidiaries	33
<i>Alternatives to lifting the veil: agency</i>	37
<i>Alternatives to lifting the veil: contractual guarantees</i>	37
<i>Alternatives to lifting the veil: tort claims against other companies</i>	38

<i>Alternatives to lifting the veil: Insolvency Act 1986</i>	39
Is the law on corporate groups deficient?	42
3. Capital Structure—Fundamental Legal, Accounting, and Financing Considerations	49
Scope of this chapter	49
Share capital terminology	49
Accounting for an allotment of shares	51
Characteristics of ordinary shares	53
Dividends	53
Capital gains and risk	53
Voting rights	54
Debt finance terminology	54
Characteristics of simple debt	56
Interest	56
Capital gain and risk	56
Control	57
Hybrid securities in outline	57
Valuation of securities	59
Shares	59
<i>Net asset value</i>	60
<i>Dividend valuation</i>	60
<i>Free cash flow valuation</i>	60
Debt securities	60
Cost of capital	61
Capital structure	62
Sources of corporate finance in the UK	66
Securities markets	68
Efficient capital markets	75
Measuring and assessing financial performance—company accounts	77
Statutory financial disclosure framework for UK companies	78
Additional financial disclosure framework under FSA	
<i>Disclosure and Transparency Rules</i>	81
Additional financial disclosure framework for other publicly traded companies	82

II. LEGAL CAPITAL

4. Formation of Share Capital	85
Scope of this part	85
Minimum price of individual shares: par values	85
Minimum capital	89

Denomination of minimum capital	93
Is any valuable purpose served by minimum capital requirements?	94
Allotted, issued, and equity share capital	97
Allotted share capital	97
Authority to allot shares	98
Registration of allotment and return of allotments	98
Issued share capital and issued shares	99
Equity share capital	100
Payment for shares	101
Introduction	101
Paid up share capital	101
Called up share capital	102
Cash consideration for shares	102
Shares must not be issued at a discount	103
<i>The no-discount rule and convertible securities</i>	104
<i>The no-discount rule and underwriting commissions</i>	105
Regulation of non-cash consideration for shares	106
Public companies must not accept an undertaking to do work or perform services as consideration for shares	107
Public companies must not accept undertakings to be performed in the future as consideration for their shares	108
Valuation of non-cash consideration for shares in a public company	109
<i>Takeover exemption</i>	111
<i>Mergers exemption</i>	112
Relaxation of the independent valuation requirement by the 2006 amending Directive	112
Liability of subsequent holders	113
Relief from liability	113
Criminal liability for breach of rules relating to payment for shares	115
Share premiums	116
Determining the issue price	116
Treatment of share premiums	116
Permissible uses for share premiums	117
<i>Bonus issues</i>	117
<i>Expenses and commissions on an issue of shares</i>	118
Share premiums and non-cash consideration	118
<i>Group reconstruction relief</i>	119
<i>Merger relief</i>	120
<i>Importance of group reconstruction and merger relief</i>	122
<i>Other reliefs</i>	123
Other capital contributions	123
Stock	123

5. Share Allotments	125
Scope of this chapter	125
Policy arguments and responses	127
Wealth transfers	127
<i>Protection against dilution</i>	129
Distortion of market for corporate control or other unconstitutional behaviour by directors	129
<i>Abuse of majority shareholder power</i>	129
Policy responses	130
Shareholder empowerment under the Companies Act 2006	131
Private company with a single class of shares	131
Authorization by company	132
Statutory pre-emption rights under the Companies Act 2006	134
Pre-emption rights in relation to 'allotments' of 'equity securities': definitions	135
The operation of the statutory pre-emption rights procedure	135
Consequences of non-compliance	138
When pre-emption rights do not apply	138
Disapplication of pre-emption rights: all companies	140
Disapplications for the purposes of making a rights issue or open offer	141
<i>Fractions</i>	141
<i>Overseas shareholders</i>	141
<i>Open offers</i>	144
Disapplications for non pre-emptive offers	144
Disapplication or exclusion of pre-emption rights: private companies	146
Other formalities in relation to share allotments	146
6. Shares	147
The legal nature of a share	147
Incidents of shares: dividends and capital	148
What financial entitlements do investors in shares acquire?	
The position of holders of ordinary shares	148
<i>Default capital rights of ordinary shares</i>	149
<i>Default dividend rights of ordinary shares</i>	149
What financial entitlements do investors in shares acquire?	
The position of holders of preference shares	151
<i>Default capital rights of preference shares</i>	152
<i>Spens formula</i>	153
<i>Default dividend rights of preference shares</i>	153
<i>Enfranchisement when preferential dividends are in arrears</i>	154
<i>Payment of accumulated unpaid preferential dividends</i>	155
What financial entitlements do investors in shares acquire?	
The position of holders of redeemable shares	156
Incidents of shares: transferability	157

Incidents of shares: voting rights	158
The juridical nature of the relationship between a company and its registered shareholders	158
Variation of rights attaching to shares	162
Provision for entrenchment	162
A class of shares	163
<i>A class of shares—some clear cases</i>	163
<i>Golden shares</i>	164
<i>Rights conditional on holding a specified percentage shareholding</i>	165
<i>Shares with different par values</i>	165
<i>Shares on which different amounts have been paid up</i>	165
<i>When class distinctions matter</i>	166
Variation of class rights	166
<i>What is a right attached to a class of shares for this purpose?</i>	167
<i>What is a 'variation' of a right attached to a class of shares?</i>	168
<i>Variation of rights by enhancement</i>	171
The procedure for variation of class rights	172
<i>Voting to alter class rights—a fettered power?</i>	173
<i>Statutory protection of minorities in a class</i>	174
Class rights and reduction of capital	174
Class rights and redemption of shares/share buy-backs	177
7. Maintenance and Reduction of Capital	179
Protection of creditors' interests: introduction	179
Questioning the value of the legal capital doctrine	180
The development of the maintenance of capital regime in the UK	184
Application of the common law rule prohibiting the return of capital to shareholders	185
An unlawful return of capital is <i>ultra vires</i>	187
Gratuitous dispositions to third parties and directors' duties	189
Reduction of capital under the statutory procedures	190
Why reduce capital?	191
Forms of reduction of capital sanctioned by the Companies Act 2006	192
<i>Limitation on use of solvency statement reduction of capital procedure</i>	192
The court approval procedure	192
Special resolution of the shareholders	192
The oversight of the court in respect of creditors' interests	193
The oversight of the court in respect of shareholders' interests	194
General powers of the court	195
Registration	196
<i>Where allotted capital is reduced below the authorized minimum</i>	196
Effect of a court-approved reduction of capital	196
Reduction of capital under the solvency statement procedure: private companies only	197
Special resolution of the shareholders and class consents	197

Solvency statement	197
Contents of solvency statement	198
Sanctions in respect of false solvency statements	199
Registration requirements relating to the solvency statement procedure	199
Effect of a reduction of capital under the solvency statement procedure	200
Exceptional reduction of capital procedures	200
Reduction of capital following redenomination of shares	200
Reduction of capital pursuant to an order of the court	201
Reduction of capital in respect of forfeited or acquired shares	201
8. Share Buy-backs and Redeemable Shares	203
Introduction	203
Arguments for and against allowing companies share buy-back/redeemable share issuance powers	203
To attract external investors	203
To facilitate exit	204
To structure a temporary loss of control	204
To return value to shareholders	204
To give information signals	205
To achieve a target capital structure	205
To expand the range of financing options	206
To buy back redeemable shares at a discounted price	206
To facilitate the organization of employee share schemes	206
To achieve an informal reduction of capital	206
To defend against a takeover or deal with dissident shareholders	207
To stabilize the share price	208
Consideration by review bodies	208
The European dimension	210
General statutory rule in the Companies Act 2006 against a company acquiring its own shares	212
Share buy-backs—authorizations required by the Companies Act 2006	213
Market purchase	214
<i>Ordinary or special resolution?</i>	214
Off-market purchase	215
Other statutory restrictions on the terms and manner of buy-backs	217
Accounting for a share buy-back	218
Treasury shares	220
Buy-back of own shares out of capital: private companies only	221
Statutory modification of contractual matters relating to share buy-backs	224
FSA regulatory requirements relating to share buy-backs	224
Takeover Code implications of share buy-backs	226

The authorizations required for an issue of redeemable shares	226
Other requirements of the Companies Act 2006 relating to redemption of redeemable shares	227
Class rights issues relating to share buy-backs and redeemable shares	228
Share buy-backs and redeemable shares and protection of minorities	228
9. Distributions to Shareholders	231
Investor expectations	231
Dividend policy	232
Dividend policy and market value	232
Dividend policy, information asymmetries, and signalling	233
Dividend policy and agency costs	234
Dividend policy and managerial-shareholder agreement levels	236
Regulation of dividend policy decisions	237
An overview of the regulatory response to agency problems relating to shareholders	237
An introduction to the regulatory response to agency problems in relation to creditors	241
Statutory regulation of distributions	242
What is a 'distribution'?	243
Profits available for distribution	245
Additional requirement for public companies	246
Relevant accounts	247
Choice of accounting regulatory framework	247
Accounting profits and profits available for distribution	248
Generally accepted principles with respect to the determination of realized profits or losses	249
TECH 7/03	250
TECH 2/07	251
Dividend payment procedure	251
Unlawful distributions	252
When is a distribution unlawful?	252
Other restrictions on dividends	254
Liability consequences of unlawful dividends	254
<i>Directors' liability</i>	255
<i>Shareholder liability</i>	256
<i>Directors' claims against recipient shareholders</i>	258
Other issues	259
Scrip dividends	259
Dividend reinvestment plans	259
Intra-group distributions	260
<i>Intra-group dividends and principles of realization</i>	260
<i>Intra-group dividends and dividend blocks</i>	260
Intra-group transfers of assets at an undervalue	261
Reform	262

10. Financial Assistance	267
Prohibition on the giving of financial assistance—some preliminary issues	267
What is ‘financial assistance’ law?	267
Legislative history	267
Who is protected by the ban?	269
Why is the giving of financial assistance banned?	269
Objections to leveraged takeovers/buyouts	269
Market manipulation	270
Unconstitutional conduct by management	271
Maintenance of capital and ‘detriment’	271
Is the ban on the giving of financial assistance justified?	272
Technical problems	272
Policy concerns	273
Outline of the legal framework	275
‘Definition’ of financial assistance	276
‘Financial assistance’ is not a technical term	276
<i>Recent cases applying the test of commercial substance and reality</i>	277
Forms of financial assistance that are prohibited	279
<i>Financial assistance given by way of gift</i>	279
<i>Financial assistance given by way of guarantee or security</i>	281
<i>Financial assistance given by way of indemnity</i>	282
<i>Financial assistance given by way of release or waiver</i>	282
<i>Financial assistance given by way of loan</i>	283
<i>Financial assistance given by way of any other agreement under which the obligations of the person giving the assistance are to be fulfilled at a time when, in accordance with the agreement, any obligation of another party to the agreement remains unfulfilled</i>	283
<i>Financial assistance given by way of novation of, or assignment of rights arising under, a loan or such other agreement</i>	284
<i>Any other financial assistance given by a company the net assets of which are thereby reduced to a material extent</i>	284
<i>Any other financial assistance given by a company which has no net assets</i>	285
Circumstances in which the giving of financial assistance is prohibited	285
An acquisition	286
The ban relates only to an acquisition of shares	286
The ban applies only to public companies and their subsidiaries	287
<i>The status of the company whose shares are acquired</i>	287
<i>The status of the company providing the assistance</i>	288
The acquirer of the shares	288
<i>Must the acquirer be known to the company providing the assistance at the time when the assistance is given?</i>	289
The assisted person—direct and indirect financial assistance	290