

Company buy-back of shares: Proceed with caution!

A company may wish to buy back its shares from a shareholder for a number of reasons. The shareholder may be retiring from the company, he may be cashing in his investment (or shares he acquired pursuant to an employees' share scheme) or he may be forced to sell his shares following the termination of his employment.

Considering it is so simple for a company to issue shares, there are a surprisingly large number of rules to consider when the company wants to "take those shares back".

Failure to comply with such rules has significant implications: The buy-back will be void, meaning the shareholder is treated as having never sold his shares (possibly having to return any money received for them) and the officers of the company may be personally liable for the default.

This information sheet will run through the various rules and highlight matters which must be taken into account before a company proceeds to buy back its own shares.

Some of the rules relating to share buy-backs have been relaxed by a statutory instrument which came into force on 30 April 2013. This information sheet will refer to that statutory instrument as the **2013 Regulations**.

As the majority of share buy-backs we deal with concern private companies, this information sheet will not consider rules which relate specifically to public companies.

Golden rules

There are three basic factors which must be considered before proceeding with a share buy-back. These are:

- Date of payment for shares.
- Distributable profits.
- Payment in cash.

Date of payment for shares

Unless a buy-back is for the purpose of or pursuant to an employees' share scheme, payment for the shares must take place on the date of the buy-back. This means that a company cannot stagger payment for the shares over a number of instalments.

One way around this requirement would be to stagger the sale of the shares, so that each time the company buys back a portion of a shareholder's shares, it pays for those shares at that time. Of course, the company must satisfy the other requirements relating to the buy-backs on each such occasion.

The downside to this work-around is that the company may not want the shareholder to retain any shares over the period of the instalments.

Another potential solution may be for the all of the shares to be bought back on a single date and for the whole price to be paid on that date, but for the shareholder to then lend part of the price back to the company as a separate transaction. The company can then repay the loan in agreed instalments.

However, this may not be possible if the reasons for wanting to pay in instalments in

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the first place include not having sufficient cash or distributable profits on the date of the buy-back (see further below).

If neither of these alternatives solve the problem, there may be other viable alternatives to a share buy-back which we can advise you on.

As mentioned above, the requirement to pay for the shares on the date of the buy-back does not apply if the buy-back is pursuant to an employees' share scheme. This is an exception introduced by the 2013 Regulations.

It makes employees' share schemes more attractive to employers and employees alike, as it eases the risk and burden of being able to finance a buy-back in full immediately upon an employee leaving employment.

Distributable profits

The most common way for a company to finance the buy back of its shares is using its distributable profits.

The test for establishing whether the company has sufficient distributable profits is broadly the same as for declaring dividends.

The directors must consider the latest annual accounts and the profitability of the company since the date of those accounts.

In addition to the company's actual liabilities appearing in those accounts, the directors must also consider the company's contingent liabilities. This means any liabilities which have not yet crystallised, but which may do so in the near future. For example, if the company has given a

guarantee in relation to the obligations of a third party (such as when it assigns a lease), it should make enquiries of the likelihood of that guarantee being enforced.

If the proposed buy-back is likely to have an adverse affect on the company's ability to discharge those contingent liabilities, it may not be able to finance the buy-back from its distributable profits.

As an additional measure to facilitate buy-backs in connection with an employees' share scheme, the 2013 Regulations have introduced the ability for a company to pay up to £15,000 or 5% of its share capital (whichever is lower) per annum without having to rely on having distributable profits.

In order to take advantage of this concession, the company's articles of association must be amended to authorise it. It will require a special resolution to amend the articles of association.

If this limit is insufficient for a buy-back in connection with an employees' share scheme, it may be possible to pay for the buy-back out of capital, provided that the directors are able to sign a solvency statement and the buy-back is approved by a special resolution.

If the buy-back does not relate to an employees' share scheme and there are insufficient distributable profits, it may still be possible for the company to finance the buy-back out of capital or using the proceeds of a fresh issue of new shares. However, each of these alternatives involves a number of additional complexities, which are outside the scope of this information sheet. Please contact us if you would like to consider either of these alternatives.

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Payment in cash

Not only must the company have distributable profits to fund the buy-back, it must also have sufficient cash.

It is not possible for the price to be settled in non-cash assets.

This would rule out a shareholder transferring his shares back to the company in exchange for part of the company's business or property.

Of course, this will not prevent the company buying back the shares for cash and the shareholder then using that cash to purchase a non-cash asset from the company, but the company would still need to have or raise the cash in the first place.

Nor is it possible to set-off an amount owing by the shareholder to the company (for example, a director's loan account) against the price payable for that shareholder's shares.

Secondary considerations

Once the company has satisfied itself on the above golden rules, the following matters must be considered:

- Tax treatment and clearance.
- Shareholders' resolution.
- Procedural formalities.
- Common pitfalls.

Tax treatment and clearance

Payment of the price for shares bought back by the company would ordinarily be treated as a distribution, meaning that the

shareholder will have to pay income tax on the price in the same way as if he was receiving a dividend (at an effective rate of 25% for a higher rate taxpayer).

However, it may be possible for the shareholder to apply to HMRC to charge his receipt of the price to capital gains tax (CGT), seeing as he is disposing of his interest in the shares.

This may be beneficial to the shareholder for so long as the rate for CGT is less than the rate for income tax, especially if the shareholder is able to benefit from entrepreneurs' relief (meaning an effective rate of 10% on share disposals) or has unutilised annual exemptions.

HMRC is only likely to agree to charge receipt of the price to CGT if the shareholder is:

- selling all or substantially all of his shares in the company; and
- ceasing to be involved in any employment or management capacity with the company.

Having said that, HMRC has been known to give clearance for CGT treatment if a shareholder agrees to sell his shares in instalments over a period of time and remains employed by the company until the final instalment, provided that it is part of a documented exit strategy.

If you wish to benefit from CGT treatment in relation to a buy-back, it is important to factor into your considerations the time it takes to obtain advance clearance from HMRC. Typically, this can take up to 30 days, provided no queries are raised by HMRC.

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Shareholders' resolution

Until the 2013 Regulations came into force, the company had to approve a share buy-back by passing a special resolution in advance of the buy-back, meaning that shareholders holding, between them, 75% of the issued shares (ignoring those shares which are subject to the proposed buy-back) must approve it.

The 2013 Regulations have lowered this threshold so that only an ordinary resolution is required (lowering the 75% figure to a simple majority).

To avoid the need to convene a general meeting to pass the resolution, it is possible to approve the buy-back by way of a written resolution.

In this case, the shareholder who is proposing to sell his shares back to the company is not eligible to sign the written resolution, so it will require shareholders who hold, between them, the necessary majority of shares held by all shareholders excluding the proposed seller to vote in favour of the resolution.

If this is not possible, and if the proposed seller is not selling all of his shares, then it may be possible to pass the resolution at a general meeting, because the proposed seller will be able to vote on those shares which are not subject to the buy-back (which might take the total number of votes over the necessary majority).

The requirement for each share buy-back to be approved by a shareholders' resolution is removed under the 2013 Regulations for buy-backs in connection with an employees' share scheme, so long as the company is generally authorised by an ordinary

resolution in relation to such employees' share scheme buy-backs.

This authority must be subject to certain restrictions as to the total number of shares which may be bought back, the price payable and the period for which such authority will last before it has to be renewed.

Procedural formalities

Articles of association

Before the company proposes the shareholders' resolution, the directors should check the company's articles of association to ensure that it has the relevant power to buy back its own shares.

Since the implementation of the Companies Act 2006, a company is deemed to be authorised to buy back its own shares unless the articles provide otherwise.

Written contract

Unless the buy-back is in connection with an employees' share scheme and there is general authority for such a buy-back (as mentioned above), there must be a written contract between the company and the proposed seller setting out the terms of the buy-back (or at least a memorandum of such terms).

If the buy-back is to be approved at a general meeting, this contract must be made available at the company's registered office for at least 15 days prior to the meeting.

If the buy-back is being approved by a written resolution, then the contract should

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accompany the resolution when it is sent to the shareholders.

The buy-back contract must be kept at the company's registered office for 10 years after the date of the buy-back.

Stamp duty

If the price payable for the shares is more than £1,000, stamp duty will be payable at ½% of the price.

Companies House

The company must file a copy of the resolution authorising the buy-back and a couple of forms at Companies House in relation to the buy-back.

Common pitfalls

We advise a number of our clients in relation to share buy-backs, and it is surprising how many of them encounter small but significant difficulties.

Pre-emption rights

If the company's articles of association contain pre-emption rights in relation to a proposed transfer of shares (meaning that such shares must be offered to the existing shareholders before they are transferred), then it may be necessary for the shareholders to waive such pre-emption rights before the buy-back takes place.

The safest way to do this would be for them to each sign a waiver, but it may also be possible to disapply the pre-emption rights by passing a further special resolution (subject to the terms of the articles and other considerations).

Fully paid up shares

Most companies have a fully paid up share capital, meaning that the price payable on the issue of the shares has been paid in full.

However, it is possible that some of the issue price may not have been paid. The shareholder will be liable to pay any unpaid amount following the company's demand.

It is not possible for a company to buy back a share which is not fully paid up.

This might cause difficulties if a shareholder is selling shares which are not fully paid up in order to raise cash. Before the company can complete the buy-back, that shareholder will need to raise some of that cash from another source in order to pay up the shares.

Class consent

If the company's share capital is divided into different classes, it may be necessary to obtain the consent of holders of some or all of such classes before the buy-back takes place.

This is often the case, for example, when there are non-voting preference shares, and the proposal is for the company to buy back some of its ordinary shares.

As the preference shares are non-voting, the holders of them would not normally be entitled to vote on the shareholders' resolution.

However, as the preference shares are likely to give their holders preferential rights to income and capital, such holders may need to specifically sanction the buy-back.

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Conclusion

If you are considering a company buy-back of shares, we hope that this information sheet highlights the main issues which you should be aware of.

The 2013 Regulations have made some of the requirements and procedures in relation to share buy-backs much less burdensome, especially in relation to buy-backs in connection with employees' share schemes. However, regardless of whether you are dealing with employees' share schemes or not, there are still many factors which must be considered to avoid falling foul of the strict requirements.

This information sheet has been prepared to highlight some of the key issues relating to share buy-backs. It is intended to be for general guidance only and is not a substitute for specific advice. It is based upon our understanding of the law as at 1 May 2013 and may be affected by subsequent changes to the law.

If you have any questions in relation to this information sheet, or if you require any assistance in implementing a share buy-back, please contact Nick Gabay on 01892 701236 or email him at

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