Repurchase of own shares for New Zealand

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New Zealand is one of the few jurisdictions in which limited companies are not permitted to repurchase their own shares. Experience abroad shows repurchase to be a versatile but potentially abusive company practice which impacts on nearly every major institution of company law. Abolition of the rule in Trevor *v.* Whitlock *is particularly problematic in New Zealand where, unlike other jurisdictions, company law, and particularly the statutory regime, have not kept pace with the evolving and often conflicting interests of management and shareholders. The rudimentary New Zealand law respecting such diverse matters as insider dealing, financial reporting, takeovers, and derivative actions gives repurchase of shares a significantly greater potential for abuse in New Zealand than attends the practice in other jurisdictions.*

I. INTRODUCTION

Unlike their counterparts in most other Western jurisdictions, companies in New Zealand and Australia may not repurchase their own shares. This peculiarity results from continued adherence to the rule in *Trevor* v. *Whitworth,* an 1887 decision of the House of Lords.[1] In *Trevor,* a closely held private company repurchased shares from retiring members at subscription prices. The legality of the transaction was put at issue when the company was wound up and one of the selling shareholders sought to enforce a promissory note taken in payment. The House of Lords, reversing the judgment in the Court of Appeal, held the obligation unenforceable primarily on the ground that repurchase circumvented the statutory rules governing reduction of capital.

For almost one hundred years Commonwealth jurisdictions followed the rule in *Trevor* whereas it was rejected early in most jurisdictions in the United States of America.[2] Influenced by practice in the United States and the Canadian experience with redeemable shares and unimpressed by the capital maintenance argument,[3] the

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1 (1887) 12 App. Cas. 409.

2 See in Re *Castle Braid Co. Ltd.* 145 Fed. 224 at 231-233 (D.C. S.D. N.Y. 1906).

3 Ontario Legislative Assembly, *Interim Report of the Select Committee on Company Law* (1967) ("Lawrence Report") at 37-38.

Ontario legislature abolished the rule in 1970.[4] Other Canadian jurisdictions soon followed suit. In the United Kingdom, as late as 1962, the Jenkins Committee found no appreciable support for modification of the rule despite the acknowledged usefulness of repurchase in the United States.[5] In 1980, the Wilson Committee and the Department of Trade suggested that repurchase be permitted as a device to promote business development.[6] After the United Kingdom's accession to the European Economic Community, Parliament seized the opportunity presented by the Second Directive (1976)[7] and, with enactment of the Companies Act 1981,[8] effectively abolished the rule in *Trevor*. Recent Australian studies have also recommended abolition of the rule.[9] The same commercial and political pressures which animated these developments abroad are undoubtedly extant in New Zealand and invite reconsideration of the rule in *Trevor* for local law.

Since repurchase of own shares operates at once as a distribution of assets, a reorganisation of ownership and a transfer of shares, reform of the rule in *Trevor* potentially involves most major doctrinal institutions of company law. For repurchase invites all the abuses associated with each of its three functions and implicates the related legal doctrines. As a share transfer, repurchase raises the spectre of insider trading and price manipulation; as a reorganisation, unfair and discriminatory treatment of minority shareholders; and as a distribution of assets, asset stripping and debt avoidance. These are only the broad headings. For instance, the significance of repurchase for capital maintenance is not confined to the financial limitations upon distributions but also extends to the rules (or, as in New Zealand, the lack thereof) respecting minimum capital, unpaid subscriptions and non-cash consideration for shares, and, at its edges, it also encompasses financial reporting requirements, the ranking and avoidance of claims in winding up and the law governing security interests in real and personal property. Because of its tripartite nature, a given repurchase transaction often involves more than a single abuse. This perhaps accounts for the intensity of the debate surrounding greenmail and going-private transactions. The massive distributions involved in a going-private transaction threaten the company's financial stability; their terms are dictated on the basis of inside information; and their execution effectively freezes out minority shareholders.

4 Business Corporations Act 1970 (Ont.), R.S.O. 1970, c. 53, s. 39.

5 *Jenkins Committee — Report of the Company Law Committee* (1962; Cmnd. 1749) at 60-61.

6 *Wilson Committee — Report of Committee to Review the Functioning of Financial Institutions* (1980; Cmnd. 7937) at 216, 390; Department of Trade, *The Purchase by a Company of its Own Shares: A Consultative Document* (1980; Cmnd. 7944) at 1.

7 Second Council Directive 77/91 of 13 Dec. 1976 on Coordination of Safeguards arts. 19-24. This Directive authorises but does not require member states to permit repurchase subject to specific rules respecting capital maintenance and corporate governance.

8 Sections 46-59, now consolidated in Companies Act 1985 (U.K.) ss. 162-178.

9 Companies and Securities Law Review Committee, *A Company's Purchase of Own Shares* (Sydney, 1986).

II. NEED FOR REPURCHASE

In United States legal practice, which generally rejects the rule in *Trevor*, repurchase transactions are particularly commonplace:

1. A closely held private company includes in its articles of association or becomes party to a separate agreement pursuant to which the company purchases the shares of any member who retires from the business (buy out agreements).
2. In order to avert a takeover, a company purchases the shares held by the potential offeror (green mail).
3. A publicly listed company acquires a sufficient number of shares to cause it to become first delisted and then a private company (going private).
4. A publicly listed company repurchases shares on a regular basis in order to facilitate administration of an employee share scheme or for use in future acquisitions.

Although companies repurchase shares for many other reasons,[10] these four transactions have received the most attention from the United States legal community.

In New Zealand, despite adherence to the rule in *Trevor*, all four transactions can be accomplished by other means. (1) An exception to the prohibition against financial assistance permits a cross purchase arrangement to be financed by company funds if the purchasing shareholder is an employee and not (except in a private company) a director.[11] Alternatively, the equivalent financial result can be achieved by means of a capital reduction at a premium or by redemption of preference shares.[12] (2) Although a target company cannot repurchase the shares held by a potential offeror, the directors can reacquire the shares themselves (management buyout) or arrange for acquisition by a subsidiary or by a friendly third party. The transaction can be internally financed by a dividend distribution or a sale of assets by or to the company.[13] (3) Although a company cannot go private by repurchasing its own shares, an insider group (usually associated with management) can repurchase the shares and internally finance the transaction by a sale of assets or a dividend. (4) Under another exception to the prohibition against financial assistance, company assets can be used to enable a trustee to purchase shares for use in an employee share scheme.[14] The availability of these alternative schemes figured strongly in the refusal of the Jenkins Committee to relax the rule in *Trevor*.[15]

III. REPURCHASE AS A COMPOSITE TRANSACTION

A repurchase of own shares can be viewed a distribution of funds to one group of shareholders on the condition that these members use the money to acquire shares from

10 For other uses of repurchase, see discussions in Cary, *Cases and Materials on Corporations* (5th ed., Foundation Press, Mineola, N.Y., 1980) at 1423; Gower, "The Purchase by a Company of its Own Shares" in Cmnd. 7944 ante, n. 6 at 9-10; Wyatt, *Company Acquisition of Own Shares* (Oyez Longman, London, 1983) at 2-3.

11 Companies Act 1955 s. 62(1)(c).

12 *Jenkins Report,* supra, n. 5 at 61.

13 See *Re Wellington Publishing Co. Ltd.* [1973] 1 N.Z.L.R. 133 and *Belmont Finance Corporation Ltd.* v. *Williams Furniture Ltd. (No. 2)* [1979] Ch. 250.

14 Companies Act 1955 s. 62(1)(b).

15 *Jenkins Report,* supra, n. 5 at 61.

the other members.[16] Division of the shareholders into two groups may be voluntary or involuntary. Where the repurchase is made by public tender, the shareholders voluntarily decide whether or not to sell and divide themselves accordingly. In contrast, where the company makes a targeted repurchase, the division is involuntary; the company selects the selling shareholders and places all others in the staying group.

The composite view reveals purchase as an inherently coercive transaction. The recipient of other company distributions (dividends, capital reductions, or share redemption) may use the distributed assets to purchase additional shares in the company, to invest elsewhere or to increase current consumption. In a repurchase of own shares, the shareholders who receive the constructive dividend have no choice but to reinvest it in the company and increase their ownership participation. The freedom of the selling group is also limited: a shareholder cannot participate in the distribution (usually of profits) unless she is willing to relinquish her shares. Repurchase by public tender forces shareholders to choose between participating in the profits and losing their shares or foregoing profits and expanding their ownership participation in the business. However, many shareholders may not view the distribution of profits as a sufficient reason for parting with their shares but at the same time may not view the alternative, further investment in the company, as a wise investment decision either. A targeted repurchase leaves the shareholders with no choice whatsoever. The vast majority of shareholders receive a constructive dividend which they use to increase their ownership share in the target. Whatever the form of repurchase, the staying shareholders increase their holdings without the benefit of the protections provided by the Securities Act 1978.

The composite view also reveals that repurchase transactions necessarily involve management in a severe conflict of interests. Remember that it is management which controls the timing and terms of repurchase and, except for public tender, also the identities of the selling and staying shareholders. If the directors hold shares, then they are interested in the transaction whether they belong to the selling or staying group. However, even if they are not shareholders, the reorganisational effect of the transaction will necessarily make them interested parties in the wider sense. Many targetted repurchases — e.g., greenmail, buyouts and going-private transactions —have as their objective the elimination of shareholders who pose an actual or potential threat to present management policies. Even repurchase of own shares by means of public tender will have control consequences of interest to the directors, since the selling group will presumably include a disproportional number of shareholders who are disaffected with present management.

IV. CAPITAL MAINTENANCE

A repurchase of own shares distributes company assets in exchange for property which possesses value only in the same sense as authorised but unissued shares. Such a

16 See Chirelstein, "Optional Redemption and Optional Dividends: Taxing the Repurchase of Common Shares" (1969) 78 Yale L.J.739, 743.

distribution threatens particularly the unsecured creditors whose de facto security is the liquidation value of the firm's net marketable assets. In this respect, repurchase of own shares resembles a dividend, capital reduction and redemption of preference shares. The present statutory regime conditions these distributions upon compliance with rules which seek to protect the creditors' equity cushion.[17] Since it is not regulated in a similar fashion, repurchase of own shares would, according to the judgments in *Trevor*, circumvent these capital maintenance rules to the detriment of creditors.[18]

It is very doubtful whether capital maintenance compels continued adherence to the rule in *Trevor*. The effect of the capital maintenance rules is made visible to creditors, if at all, through the operation of the external reporting requirements. However, these external reports as well as the rules themselves are expressed in accounting concepts which, in law and practice, management may manipulate at its convenience.[19] The group of creditors with whom we are most concerned, the unsecured creditors, seldom if ever review financial statements before extending credit[20] and, were they to do so, it is unlikely that they could comprehend their content. Further, capital maintenance remains a chimera in any system (such as New Zealand) where the law: permits establishment of companies without minimum capital; does not require that shares be paid up; provides no procedure for ensuring that non-cash consideration approximate the value of new shares; and denies creditors standing to enjoin wrongful payment of a dividend.[21] Finally, the rules do nothing to prevent mismanagement or over-indebtedness which pose far greater threats to the equity cushion than do wrongful distributions of capital.

The funding of share repurchases is, not surprisingly, raised most commonly in insolvency proceedings. In this context, creditors may derive some protection from the

17 Companies Act 1955 ss. 66(1), 75-79 and 3rd Sch. Table A reg. 116.

18 (1887) 12 App. Cas.409 at 416-417 (per Lord Herschell), 423-424 (per Lord Watson), 433-435 (per Lord Macnaghten).

19 The Courts have long held the view that determination of profit is a matter left to sound discretion of management. See *Ammonia Soda Co.* v. *Chamberlain* [1918] 1 Ch. 266 at 283, 289-290. Accepted accounting practices which enable management to manipulate profits include: recognition of profits resulting from revaluation of assets; manipulation of depreciation allowances; equity accounting; use of low par shares in takeovers; acceleration and postponement of revenue and expenses. See New Zealand Society of Accountants Statement of Standard Accounting Practice No. 3 (1984) [depreciation], No. 2 (1974) [equity accounting], No. 17 (1985) [revaluation of assets by property investment companies], Technical Practice Aid No.3 (1981) [revaluation of assets by other companies], Companies Act 1955 ss. 64B, 64C [issuance of shares at a premium in scheme of acquisition].

20 See the results of a survey by S. Keef in Dugan & Keef, *Repurchase for New Zealand — A Legal and Financial Analysis* (manuscript, on file at Victoria University Law Faculty Library, 1985).

21 Gower, *Principles of Modern Company Law* (4th ed., Stevens & Sons, London, 1979) at 237 n. 50 concludes that a creditor, unless it has a security in jeopardy, cannot restrain payment of an unlawful dividend. Management's obligations to creditors was mooted in *Nicholson* v. *Permakraft (NZ) Ltd.* [1985] 1 N.Z.L.R. 242 (CA). Compare Companies Act 1985 (UK) ss. 117-118 (minimum capital requirement for public companies), s. 101 (public company shares to be one-fourth paid up), s. 103 (independent valuation required for non-cash consideration given for shares), s. 263(3) (dividends payable only after elimination of prior losses).

capital maintenance rules, e.g., when the liquidator or official assignee brings an action against the directors for paying a dividend in the absence of sufficient profits.[22] However, in insolvency proceedings, creditors can be protected from the financial consequence of repurchase by rules less drastic than the prohibition in *Trevor* and less complex than the usual financial constraints upon distributions. Courts in the United States have long dealt with the specific dispute in *Trevor* by subordinating an unpaid seller's claim to the claims of all other unsecured creditors.[23] This rule has been adopted in the new English legislation.[24] Rules governing preferential transfers facilitate the recovery of wrongful distributions and, more importantly, can limit the enforcement of floating charges, the single greatest threat to unsecured creditors.[25]

Legislation in other jurisdictions reflects recognition of the deficiencies inherent in the traditional capital maintenance regime. Recent company law enactments generally impose a uniform financial constraint upon redemptions, repurchase and dividends in recognition of the functional similarity of these distributions.[26] The English legislation — influenced by Council Directives — permits these distributions only to the extent of profits,[27] resolves some of the more notorious ambiguities associated with the concept of profit,[28] and dictates an appropriate accounting treatment.[29] In contrast, the Canadian

22 E.g. *Dovey* v. *Cory* [1901] A.C. 477 and *Re Day-Nite Carriers Ltd.* [1975] 1 N.Z.L.R. 172.

23 *Robinson* v. *Wangemann* 75 F. 2d 756 (5th Cir. 1935).

24 Companies Act 1985 (U.K.) s. 178(6); *accord* Canada Business Corporations Act 1974-75-76 (Can.) c. 33, s. 38(3).

25 In *Salomon* v. *Salomon & Co.* [1897] A.C. 22 at 53 Lord Macnaghten called the practice of floating charges "a great scandal". Other jurisdictions place more severe constraints upon the enforceability of such securities both inside and outside insolvency proceedings. E.g. 11 U.S.C.A. s. 547 (U.S.A) [floating charge as voidable preference]; Uniform Commercial Code s. 9-312(3) [priority of purchase money security over floating charge]; BGHZ 55, 34 (West German court of final appeal holds floating charge unenforceable as unconscionable restraint upon debtor's freedom to manage own business affairs). Companies Act 1955 s. 309 would apply where, on the eve of winding up, a company pays promissory notes such as those involved in *Trevor* and s. 311C would often apply where a director/shareholder uses repurchase to bail out of a failing business.

26 E.g. Companies Act 1985 (U.K.) s. 263; Canada Business Corporations Act 1974-75-76 (Can.) c. 33, ss. 32, 34, 40; California General Corporation Law (Compact ed., West, 1986) ss. 166, 500.

27 Companies Act 1985 (U.K.) ss. 263(1), 263(2).

28 Ibid., s. 263(3) (requirement that profits be realised and prior losses be eliminated before any distribution), s. 275(3) (depreciation on revalued assets), s. 276 (distribution of appreciated assets), s. 269 (development costs).

29 Ibid., s.170(1) [similar to the rule applicable to redemptions under Companies Act 1955 (N.Z.) s.66(1)(d)]. In the absence of such legislative fiat, accountants appear unable to agree on the manner in which to report repurchase transactions. In many United States jurisdictions, a similar distribution rule (repurchases only out of earnings and mandatory cancellation of repurchased shares) has, in the absence of a mandated accounting rule, resulted in at least three different implementations, the most common of which permits the same earnings to be used repeatedly to finance successive repurchases. See Cary, supra, n. 10 at 1426-1431 and Board of Trade Company Law Committee, *Minutes of Evidence Taken Before the Committee* (H.M.S.O. 1962) vol. 2 at 1001.

statute and Model Business Corporations Act subject these distributions to only a uniform solvency constraint.[30]

Whereas the new English statute expands and complicates the rules governing capital maintenance, the North American approach results in a noticeable simplification. Both approaches recognise that some repurchase transactions, — e.g., those pursuant to gift or court order — pose no threat to creditors and should be exempted from the rules. The English statute also provides that private companies may purchase shares out of capital upon compliance with a complicated procedure involving a directors' declaration, an audit, a special resolution, publicity and opportunity for objection by members and creditors.[31] Under the North American approach, there is no need to provide concessionary treatment for private companies. Also noteworthy is that recent enactments close some of the more visible gaps —e.g., minimum capital and paying-up requirements — in the traditional capital maintenance regime, strengthen financial reporting requirements and enhance the position of unsecured creditors in insolvency distributions.

V. MANIPULATION OF SHARE PRICES

Repurchase of own shares can, depending upon the circumstances, affect the market price of the shares in a number of ways: the additional demand may increase the share price; the reduced volume of tradeable shares may push it down; and the signalling effect (what repurchase tells investors about the company) can move it up or down. Concern with this aspect of repurchase may underlie the frequent references in *Trevor* to "trafficking in shares" and perhaps even explains the result in that case.[32]

The case law in the United States documents numerous instances where companies use repurchase to influence share prices.[33] In particular, the pricing effects of share repurchase commonly figure in offensive and defensive tactics employed in take-over contests. A target company may repurchase its own shares in an effort to increase their price over the bid price.[34] The instigator of a going private transaction — whether it be management or the company itself — may seek to reduce the cost of a public tender by

30 Canada Business Corporations Act 1974-75-76 (Can.) c. 33, ss. 32, 34, 40; American Bar Association, Model Business Corporation Act 1979 s. 45. Under both regimes a company may distribute assets as long as the distribution does not render the company insolvent in either the equity sense (unable to meet current debts) or the bankruptcy sense (liabilities in excess of assets). For an interesting variation, see California General Corporation Law s. 500 (Compact ed. West 1986).

31 Companies Act 1985 (U.K.) ss. 171-177.

32 At the time of *Trevor,* the collapse of several large Continental businesses had been preceeded and perhaps precipitated by extensive repurchase programmes aimed at supporting share prices. See Nussbaum, "Acquisition by a Corporation of its own Stock" (1935) 35 Columbia L. Rev. 971 at 972-974. Since the dispute in *Trevor* could have been resolved on a number of much narrower grounds, the case perhaps represents a judicial decision to erect a permanent barrier against such practices in the United Kingdom.

33 E.g. *Davis* v. *Pennzoil Co.* 264 A. 2d 597 (Pa. 1970).

34 *Crane Co.* v. *Westinghouse Air Brake Co.* 419 F. 2d 787 (2d Cir. 1969).

means of a preliminary programme of repurchases aimed at contracting the number of outstanding shares. The reduced liquidity of the remaining shares will depress the market price and also place the shareholders under coercion to sell.[35]

Among the many abuses associated with repurchase of own shares, price manipulation is surely one of the most insidious. The inflationary potential of repurchase surely tempts directors who, unable to steer their firm on profitable course, must conceal the difficulty or lose office. Such manipulation not only conceals the underlying difficulty, it also works a fraud on the selling parties and, for creditors and the investing public including the remaining shareholders, imputes an erroneous market value to the firm. Since share prices provide a major criterion for assessing management performance, such manipulative conduct subverts corporate governance.

New Zealand law regulates share price manipulation only as a criminal offence under a statute which clearly fails to anticipate modern forms of share market chicanery including misuse of the repurchase device.[36] The *mens rea* requirement and lack of civil remedies effectively place this type of corporate misconduct beyond the reach of the law.[37] Not surprisingly, the published case law from jurisdictions with similar statutes records not a single prosecution for share price manipulation. In contrast, legislation in the United States and Australia subjects a wide range of manipulative conduct to severe criminal liability and provides a civil remedy to any party aggrieved by such misconduct.[38]

A simple prohibition upon share price manipulation, whether implemented by penal sanction and/or civil remedy, whilst probably necessary to protect the integrity of a share market, can frustrate legitimate share repurchase transactions. This is particularly true in respect to repurchase programmes aimed at maintaining an inventory of own shares for use in employee share schemes and future acquisitions. In testimony before the Jenkins Committee, representatives of companies in the United States testified that their firms went to extreme lengths to prevent repurchase from having an actual or perceived impact upon share prices.[39] Nevertheless, companies engaged in such repurchase programmes face the danger that their repurchases will, after the fact, be alleged to have manipulated share prices. In recognition of this problem, the Securities Exchange Commission (U.S.A.) found it necessary to enact a "safe harbour" exception to the prohibition against manipulative conduct. Under this complex rule, a company's repurchase of own shares will not be found manipulative solely by reason of the fact that it complies with certain rules governing the timing, lot size, price paid and brokerage arrangements.[40]

35 Securities Exchange Commission (U.S.A.), "Interpretative Release Relating to Going Private Transactions" 17 C.F.R. 241.17719 (13 April 1981).

36 Crimes Act 1961 s. 257 (conspiracy to affect by fraudulent means the public market price of shares).

37 See criticism of a similar Canadian provincial statute by Getz, "Some Aspects of Corporate Share Repurchases" (1974) 9 U.B.C. Law Rev. 9 and 35-36 (1974).

38 See Securities Exchange Act 1934 (U.S.A.) ss. 9(a), 9(3) = 15 U.S.C.A. ss. 78(i)(a), 78i(e); Securities Industry Act 1980 (Cth) ss. 123, 130.

39 See testimony of Messrs. Schwarz and Morgan in *Minutes,* supra n. 29 at 1002-1003.

40 17 C.F.R. s. 240.10b-18.

VI. INSIDER TRADING

When a company repurchases its own shares, it invariably possesses knowledge of facts not available to all shareholders or the general trading public. Case law from the United States, which reflects over a half century's experience with repurchase transactions, witnesses the fact that management does not hesitate to exploit this informational imbalance. In buy-out transactions, management withholds material facts which, if known, would have enabled the selling shareholder to demand a higher price.[41] Similar complaints arise in takeovers and going-private reorganisations the success of which depends critically upon concealment of the inside information from the selling members.[42]

New Zealand law imposes few constraints upon insider trading. The decision in *Coleman* v. *Myers,*[43] which held directors civilly liable for purchasing shares without disclosing material information, may provide a remedy in buy-out transactions. However, the case probably does not apply to transactions effectuated over the share market or through an independent broker. Guidelines promulgated by the New Zealand Stock Exchange place minimal constraints upon directors who deal in shares of their own company[44] and the Take-Over Code in the Stock Exchange's Listing Requirements prohibits directors from dealing or tipping after becoming aware of the take-over offer unless they first inform the market.[45] These requirements have only the force of contract,[46] provide no remedies to aggrieved shareholders and do not apply to a company dealing in its own shares. In most other jurisdictions, insider trading now results in criminal and/or civil liability.[47] Under USA and Canadian law, the insider trading rules apply to companies when dealing in their own shares and case law documents, if not the effectiveness of this regime, at least the incidence of the abuse.[48]

41 *Arber* v. *Essex Wire Corp.* 490 F. 2d 414 (6th Cir. 1974); *Bruce* v. *Rosenberg* 463 F. Supp. 673 (E.D. Wis. 1979); *Rogen* v. *Ilikon Corp.* 361 F.2d 260 (1st Cir. 1966).

42 *American General Insurance Co.* v. *Equitable General Corp.* 493 F. Supp. 721 (E.D. Va. 1980); *Issen* v. *GSC Enterprises Inc.* 508 F. Supp. 1278 (N.D. Ill. 1981).

43 [1977] 2 N.Z.L.R. 298 (C.A.).

44 CCH, *New Zealand Company Secretary's Manual* (1985) para. 2-147.

45 NZ Stock Exchange Listing Requirements ss. 602, 603 in CCH, *New Zealand Company Secretary's Manual* (1986) para. 8-950.

46 *New Zealand Stock Exchange* v. *Listed Companies Assn. Inc.* [1984] 1 N.Z.L.R. 699 (C.A.).

47 Company Securities (Insider Dealing) Act 1985 (U.K.) (criminal liability); Canada Business Corporations Act 1974-75-76 (Can.) c.33, ss. 121-125 (criminal and civil liability); Securities Industry Act 1980 (Cth) ss. 128-130 (criminal and civil liability); in the U.S.A., insider dealing is held to be a "manipulative or deceptive" practice prohibited by Rule 10b(5), 17 C.F.R. s. 240.10b(5) promulgated under Securities Exchange Act 1934 s.10(b) = 15 U.S.C.A. s. 78j(b), violation of which gives rise to penal liability under 15 U.S.C.A. s. 78ff and to civil liability under the case law; in 1984 the statute was amended so as to subject inside dealers also to a civil penalty up to three times the "profit gained or loss avoided as a result of the unlawful purchase or sale". 15 U.S.C.A. s. 78u(d)(2)(A).

48 Canada Business Corporations Act 1974-75-76 (Can.) c.33, s.125(1)(b). For instances where companies have been held civilly liable, see *Rogen* v. *Ilikon Corp.*, supra, n. 41 and *American General Insurance Co.* v. *Equitable General Insurance Corp.*, supra, n. 42. In contrast, the Companies Securities (Insider Dealing) Act 1985 (U.K.) apparently does not apply to companies dealing in own shares.

VII. REPURCHASE OF OWN SHARES IN TAKE-OVERS (GREEN MAIL AND GOING PRIVATE)

Repurchase of own shares serves as a versatile defensive and offensive tactic in take-over battles. A reluctant target company may defuse a potential take-over by purchasing the shares held by the perceived raider (greenmail).[49] A target company may defeat a bid by repurchasing a large number of outstanding shares, thereby consolidating control in the hands of friendly insiders. Alternatively, it may dilute the voting power of a threatening block of shares by issuing new shares to a white knight and sweeten this issue with an option to repurchase the shares and or increase the voting strength of the block by purchasing own shares.[50] By means of repurchase, the target company may seek to increase the price of shares above the bid price and/or rid itself of the liquid assets which makes it an attractive target in the first place.[51] As an offensive tactic, repurchase of own shares provides the vehicle for going-private reorganisations which are little more than internal takeovers.[52] Repurchase programmes also facilitate management buy-outs by reducing (at company expense) the number of shares which the protagonists must acquire in order to gain control of the company; the reduced liquidity of the outstanding shares may also depress the price of those shares and place the remaining shareholders under coercion to sell.

Of these tactics, greenmail and going private have received most attention from the legal community which perceives both transactions as abusive in many respects.[53] They entrench management at company expense, place directors in an intolerable conflict of interest situation, involve discriminatory treatment of shareholders and, according to most empirical studies,[54] result in a reduction of the company's market value. In addition, going private transactions also: defeat the shareholders' expectation of a liquid investment and the protection provided by public status and share market listing; proceed according to terms (e.g., prices) fixed unilaterally by management under circumstances which invite overreaching; divert future profits to one group of shareholders at the expense of another group; invite profit-taking on long-term swings in sharemarket movement; frequently employ objectionable freeze-out devices; and entail expenditures of company funds which are seldom recovered by increased efficiency or reduced compliance costs.[55]

49 E.g., *Crane* v. *Harsco Corp.* 511 F. Supp. 294 (D. Del. 1981); *Cheff* v. *Mathes* 199 A.2d 548 (Del. Ch.1964).

50 *S.E.C.* v. *Carter Hawley Hales Stores Inc.* 587 F. Supp. 1248 (C.D. Calif. 1984) aff'd 760 F.2d 945 (9th 1985); *Chris-Craft Industries Inc.* v. *Piper Aircraft Corp.* 480 F.2d 341 (2d Cir. 1973).

51 E.g., *Crane Co.* v. *Westinghouse Air Brake Co.*, supra, n. 34.

52 E.g., *Kaufman* v. *Lawrence* 385 F. Supp. 12 (S.D. N.Y. 1974), *Issen* v. *GSC Enterprises Inc.*, supra, n. 42.

53 See Brudnèy, "Equal Treatment of Shareholders in Corporate Distributions and Reorganisations" (1983) 71 Calif. L. Rev. 1072 at 1091-1114 and Bradley & Rosenzweig, "Defensive Stock Repurchases" (1986) 99 Harv. L. Rev. 1377.

54 See Note, "Greenmail: Targeted Stock Repurchase and the Management-Entrenchment Hypotheses" (1985) 98 Harv.L. Rev. 1045; Bradley & Wakeman, "The Wealth Effects of Targetted Share Repurchases" (1983) 11 J. Fin. Econ. 301.

55 See Brudney, "A Note on Going Private," (1975) 61 Virginia L. Rev. 1019, 1024-1034; Interpretative Release, supra, n. 35.

In Canada and the United States, going private transactions are subject to the same or similar rules as apply to take-overs by outsiders. In both jurisdictions, prospective offerees must be supplied with detailed information respecting the terms of the offer and value of the shares.[56] This requirement, which leaves relatively little room for operation of the insider trading rules, serves to correct the informational imbalance which exists between a company and its shareholders. The Canadian regime reduces pressure on shareholders and encourages competing bids from outsiders in that it imposes, for full and partial offers respectively, a ten day and twenty one day delay between the bid and the taking up of shares.[57] The Canadian statute also ensures equal treatment of shareholders by requiring that all shareholders receive the highest price paid for shares whether paid pursuant to a public tender or privately negotiated sale.[58]

Although generally condemned, greenmail, like other defensive tactics, has largely escaped legislative regulation. Under Canadian and English law, one of its abuses (unequal treatment of shareholders) is severely curtailed by regulation of two-tiered and partial tender offers. Under the City Take-Over Code, once a party acquires more than thirty percent of the outstanding shares, it must acquire all the shares.[59] This rule makes take-overs more expensive and this reduces the likelihood of greenmail. In Ontario, the requirement of a follow-up offer may have a similar indirect effect.[60] In the United States, greenmail is a multimillion dollar business largely unconstrained by either legislation or common law.[61] The Securities Exchange Commission (U.S.A.) recently proposed legislation which would prohibit targetted repurchases at premium prices from holders of more than three percent of the shares unless the other shareholders approve of the payment or the same offer is made to all shareholders.[62]

New Zealand law is almost bereft of rules suitable for regulation of greenmail or going private transactions. The take-over statute, already rudimentary by comparison with its counterparts abroad, does not apply to internal take-overs. It does apply to a management buy-out but only in the unlikely event that the offerors choose to operate under the statute.[63] Judicial redress for shareholders aggrieved by greenmail and going

56 17 C.F.R. s. 240.13e (U.S.A.); Canada Business Corporations Act 1974-75-76 (Can.) c.33, ss. 187-198.

57 Canada Business Corporations Act 1974-75-76 (Can.) c.33, s. 189.

58 Ibid., s. 190(d).

59 Panel on Take-overs and Mergers, City Code on Take-Overs and Mergers (1985) Rule 9.1.

60 Securities Act 1978 (Ont.) s. 91.

61 In the U.S.A. since 1983 at least eight investors have each made between $32 million and $400 million in profits through greenmail; Note, supra n. 54 at 46. From January 1979 to March 1984, American firms paid about $5.5 billion dollars (U.S.) for targetted purchases of own shares; S.E.C., "The Impact of Targetted Share Repurchases (Greenmail) on Stock Prices" in CCH, *Federal Securities Law Reports* para. 83,713 (1984).

62 Note, supra n.54 at 1063.

63 Since the Act only applies to offers in writing, per *Multiplex Industries Ltd.* v. *Speer* [1966] N.Z.L.R. 122 (C.A.), and the courts narrowly construe this requirement, most takeovers can be accomplished outside the Act if the offeror elects to stand in the market for the target shares; see *Tatra Industries Ltd.* v. *Scott Group Ltd.* (1983) 1 N.Z.C.L.C. 98648 (H.C.). Other takeovers can be routed through the exception in the Companies Amendment Act 1963 s. 3; see Securities Commission, *Company Takeovers* (Wellington 1983) vol. 2 at 41-43, 57.

private reorganisations must be sought either under section 209 of the Companies Act 1955 or in a derivative action alleging breach of management's fiduciary obligation to the company.[64] However, it will frequently be difficult — particularly in the case of publicly listed companies — to qualify a derivative action under one of the exceptions to *Foss* v. *Harbottle*.[65] As regards section 209, the relatively meagre case law on oppression and prejudicial conduct leaves little scope for challenging either practice.[66] In this type of litigation, management will invoke the business judgment rule which in United States practice has proved the undoing of most such suits.[67]

VIII. CONTRACT LAW PROBLEMS

Many repurchase agreements are concluded far in advance of the time set for their performance. This is true of buy-out arrangements, repurchase agreements used in employee share schemes, as well as option terms associated with the issue of shares to a white knight. Financial restrictions upon repurchase transactions generally apply at the time of performance and not at the time at which the agreement is concluded.[68] Accordingly, at the time of contracting there is no certainty that the company will be able to perform the agreement. The possible and actual unenforceability of the agreement gives rise to troublesome contract law problems.

Under the doctrine respecting mutuality of obligation, the possible unenforceability of the agreement due to financial restrictions may preclude the company from enforcing the contract against a shareholder. The highly respected New York Court of Appeal so held in *Topken, Loring and Schwarz Inc* v. *Schwarz* where a company sought to enforce a buy out agreement against a retiring shareholder.[69] The agreement was held unenforceable since it purported to bind the shareholder but, due to the possible consequence of the financial restrictions upon repurchase, left the shareholder without a corresponding right against the company. The decision, not universally followed in other United

64 Outside of s. 209, a direct action for injunctive relief may in some cases be predicated upon *Howard Smith Ltd.* v. *Ampol Ltd.* [1974] A.C. 821.

65 (1843) 2 Hare 461.

66 Successful actions under s. 209 have all involved the freezeout of minority shareholders in closely held private companies. See *Re Federated Fashions (N.Z.) Ltd.* (1981) 1 N.Z.C.L.C. 98109 (H.C.); *Gilks* v. *Marsh* (1982) 1 N.Z.C.L.C. 98539 (H.C.); *Clemens* v. *Clemens Bros. Ltd.* [1976] 2 All E.R. 268. Minority shareholders have not succeeded in using s. 209 as a means to obtain judicial review of alleged mismanagement. See *Thomas* v. *H.W. Thomas Ltd.* [1984] N.Z.L.R. 686 (C.A.).

67 Compare *Cheff* v. *Mathes* with *Crane* v. *Harsco Corp.* both supra, n.49. The judiciary's deference to bona fide management decisions is particularly apparent in *Thomas* v. *H.W. Thomas Ltd*, idem, and it has animated the judiciary's antipathy towards derivative actions since *Foss* v. *Harbottle*, supra, n. 65.

68 Canada Business Corporations Act 1974-75-76 (Can.) c.33, ss. 32, 38(1); Companies Act 1985 (U.K.) s. 178(3), 178(5); *Kleinberg* v. *Schwarz* 208 A.2d 803 (N.J. App. 1965) aff'd 214 A.2d 313 (N.J. 1965).

69 163 N.E. 735 (N.Y. 1928) (per Cardozo J.) English contract law also appears to recognise the mutuality doctrine; see *Kier & Co.,* v. *Whitehead Iron & Steel Co.* [1983] 1 ALL E.R. 591, 594 where the court observed that under certain conditions a requirements contract may be unenforceable for want of mutuality of obligation.

States jurisdictions,[70] resulted in enactment of statutory provisions which abrogate the mutuality doctrine in respect of repurchase transaction.[71]

Where, at the time of performance, the financial restrictions prohibit repurchase, the doctrines of breach, illegality, impossibility and frustration of purpose invite a wide range of possible resolutions ranging from specific performance against the company to cancellation of the entire contract.[72] Not surprisingly, the question does not appear to have been litigated. Parties to such agreements go to great lengths to avoid the problem.[73] Where such efforts have failed, the company will normally find itself in insolvency proceedings where special rules govern the unpaid seller's claim[74] and preempt consideration of the contract law consequences of the financial restriction.

IX. STATUS OF REPURCHASED SHARES

Whether repurchased shares are cancelled, revert to authorised but unissued shares or are treated as treasury shares (issued shares held by the company in its own name) impacts upon issues as diverse as financial reporting and corporate governance. For instance, unless prohibited by special rules, treasury shares: can be resold without regard to preemptive rights or prospectus requirements; entitle the company to a dividend and voting rights; appear as an asset on the company's balance sheet; and result in a current profit or loss upon disposition. If allowed, these practices enable management to immunise itself from outside control and to circumvent the rules respecting capital maintenance and dilution of shareholder ownership.

These problems will not arise where the law mandates that reacquired shares automatically revert to the status of authorised but unissued shares. However, of the jurisdictions surveyed, only California has implemented this straightforward solution, although the federal Canadian statute also adopts it except for shares held in a representative capacity or as security.[75] In other United States jurisdictions, the perceived advantages associated with an inventory of treasury shares (for use in future acquisitions or employee share schemes without regard to preemptive rights or registration requirements) has precluded this approach; however, the statutes typically

70 E.g., *Cutter Labs Inv.* v. *Twining,* 34 Cal. Rptr. 317 (App. 1963).

71 New York Business Corporation Law s. 514(b), (McKinney 1986).

72 In New Zealand the outcome is made even more uncertain by the unpredictable application of the Illegal Contracts Act 1970; see *Porirua Concrete Products Ltd.* v. *Reeve* (1983) 1 N.Z.C.L.C. 98706 (H.C.) and *Coleman* v. *Myers* [1977] 2 N.Z.L.R. 225 at 284-289 (H.C.) (both involving transfers allegedly made in violation of the Companies Act 1955 s. 62).

73 Such agreements typically provide that the shares will be held in escrow subject to payment in full, that the company must establish a sinking fund to finance the repurchase, that profits must be used to satisfy repurchase obligations before payment of dividends, etc. See O'Neal, *Close Corporations* (2d ed. Calleghan, Mundelein, Ill., 1971) para. 7.10 n.11.

74 Supra, nn. 22-25 and accompanying text.

75 California General Corporation Law s.510(a) (Compact ed. West 1986); Canada Business Corporations Act 1974-75-76 (Can.) c.33, ss. 37(5), 37(6), 30, 31.

provided that treasury shares do not carry dividend or voting rights,[76] and generally accepted accounting principles prohibit showing treasury shares as an asset on the balance sheet.[77] The recent English legislation anticipates that reacquired shares normally be cancelled;[78] but, in some cases, as much as three years may elapse before cancellation is mandatory during which time the company may dispose of the shares.[79] During this interlude, although the company may not vote the shares,[80] they may be shown as an asset on the balance sheet.[81]

X. FINANCIAL ASSISTANCE

Were the rules governing financial assistance, as frequently thought,[82] a necessary corollary to *Trevor*, abolition of the rule in *Trevor* would justify repeal of that much maligned regime.[83] Although both repurchase and financial assistance reduce a company's liquidity and, since not usually concluded at arms length, probably threaten a diminution of its net assets, *Trevor* and section 62 aim at two quite different types of conduct. Whereas the rule in *Trevor* prevents shareholders from bailing their investment out of a distressed company, the financial assistance rules curtail boot-strap acquisition of company control.[84] In recognition of the different purposes served by the two doctrines, the Canadian and English statutes, which abolish the rule in *Trevor*, retain but modify the prohibition against financial assistance.

Under the English statute, companies remain prohibited from giving financial assistance directly or indirectly for the purpose of acquiring shares.[85] The prohibition does not apply to a long list of specific transactions some of which may be funded only out of distributable profits[86] or, more generally, where the assistance comprises an

76 New York Business Corporation Law s. 612(6) (McKinney 1986).

77 Kieso & Weygandt, *Intermediate Accounting* (3d ed., John Wiley & Sons, New York, 1980) at 660.

78 Companies Act 1985 (U.K.) ss. 162(2), 160(4).

79 Ibid., ss. 146(2), 146(3).

80 Ibid., s. 146(4).

81 Ibid., Sched. 4, Rule 8, Formats 1 and 2, items B.III.7 and C. III. 2. This accords with Second Council Directive 77/91 of 13 Dec. 1976 art. 22(1)(b); see also Fourth Council Directive 78/660 of 25 July 1978 art. 9.

82 The prohibition resulted from the recommendation of the Greene Committee which viewed it as necessary to prevent circumvention of *Trevor; Greene Committee — Report of the Company Law Amendment Committee 1925-26* (1926; Cmd. 2657) at paras. 30-31. See also Barrett, "Financial Assistance and Share Acquisitions" (1974) 48 A.L.J. 6 at 7 (prohibition has its "basis" in *Trevor*).

83 For criticism and suggested reform, see Russell, "Section 62 of the Companies Act" [1982] N.Z.L.J. 194; Gower, *Principles of Modern Company Law* (4th ed., Stevens & Sons, London 1979) at 227.

84 These two different paradigms dominate, respectively, the judgments in *Trevor* and discussions of financial assistance in the *Jenkins Report,* supra n. 5 at para. 173 and the *Greene Report,* supra, n. 82 at paras. 30-31.

85 Companies Act 1985 (U.K.) s. 151.

86 E.g., winding up distributions, allotment of bonus shares, judicially approved reductions of capital, redemption or repurchase of shares, transactions pursuant to a court order, loans in ordinary course of business and provisions for share employee schemes. Ibid. ss. 153(3), 153(4).

incidental part of some larger business of the company and is given in good faith and in the interest of the company.[87] Private companies may generally provide assistance if it does not reduce net assets, or to the extent that it does, the assistance is funded out of profits.[88] The assistance must be approved by a special shareholder resolution made after a statutory declaration by the directors which describes the assistance, identifies the assisted party and states that the directors are of the opinion that the assistance will not render the company unable to pay its debts.[89]

The Canadian statute starts with the prohibition that a company may not give financial assistance to any shareholder, director, officer or employee for whatever reason or to any person for the purpose of acquiring shares.[90] The rule does not apply to loans made in ordinary course by financial institutions, on account of expenditures incurred on behalf of the company, and to employees for purchase of shares under an employee share scheme.[91] The initial prohibition is generally overriden by a general exception that, in other cases, financial assistance is permitted unless there are reasonable grounds for believing that the loan would render the firm unable to pay its liabilities as they become due or would reduce the realisable value of its assets to an amount less than the aggregate of the company's liabilities and stated capital, the same solvency test as applied to distributions. The Canadian and English statutes, by subjecting financial assistance to the same basic rules as apply to dividends, redemptions and repurhase, eliminate much of the "overkill" effect of the original prohibition.

A still more liberal approach to financial assistance is found in United States jurisdictions most of which limit regulation of financial assistance to a requirement that shareholders approve of loans to directors; and the most recent enactments omit even this requirement.[92] However, it should be noted that in the United States there are other safeguards against the abuses which prompt continuation of the financial assistance rules in the United Kingdom. United States law encourages derivative and class actions by shareholders, places directors under a general fiduciary obligation directly to shareholders, subjects insider trading to civil liability and makes it far easier for creditors to pierce the corporate veil. These doctrines, none of which exist at English law, provide legal recourse for disgruntled creditors and minority shareholders in the event that management should choose to waste corporate assets for whatever purpose, including loans to themselves or other insiders for the purpose of acquiring control of the company.

87 Ibid., s. 153(1).

88 Ibid., s. 155(2).

89 Ibid., ss. 155(6), 156.

90 Canada Business Corporations Act 1974-75-76 (Can.) c. 33, s. 42(1).

91 Ibid., s. 42(2).

92 See Model Business Corporations Act 1979 s. 47 (shareholder approval required for loans to directors but not for loans to employees); California General Corporation Law s. 315 (Compact ed. West, 1986) requirement for shareholder approval not required where company has more than one hundred shareholders and the articles so provide).

XI. NOMINEE TRANSACTIONS

As is true of other doctrines of company law, any regime for repurchase of own shares must accommodate nominee transactions which serve as a substitute for repurchase.[93] For instance, where a company wishes to reduce the number of shares outstanding (e.g., in order to frustrate a takeover attempt), acquisition by a nominee serves the same purpose as repurchase by the company. Alternatively, if management wishes to neutralise the hostile votes associated with a large block of shares, it may, as an alternative to repurchasing those shares, either dilute the block by issuing new shares to a nominee or arrange for acquisition of the hostile shares by a nominee.

As a general rule, the more complex the regime for repurchase of own shares, the more complicated must be associated rules for nominee transactions. At one extreme, the United States jurisdictions which impose virtually no restraints upon repurchase provide in respect to nominee transactions only that a person who holds shares in a representative capacity is not personally liable for the unpaid subscription price but that funds in such a person's hands are liable for such obligations.[94] In contrast, the English legislation which establishes by far the most complex regulation of repurchase transactions includes equally complicated rules for nominee transactions.[95] Under the English statute, the consequences of a nominee transaction depend upon numerous factors; e.g., whether the shares were issued to the nominee or acquired by the nominee from a third party, whether they were acquired with or without financial assistance, whether or not the company has a beneficial interest in the shares, whether the company is a public or private company and whether the shares were issued as fully or partially paid.[96]

XII. TAXATION

Not surprisingly, the composite nature of share repurchases which is the underlying cause of many of the legal problems discussed in this paper also complicates the taxation of such transactions. This is particularly the case in any jurisdiction which, like New Zealand, taxes dividends and capital gains at different rates. In some circumstances the distribution resembles a dividend: for instance where a closely held private company

93 The use of nominee transactions as a substitute for repurchase was considered (and approved) by the House of Lords in *Cree* v. *Somervail* (1879) 4 App. Cas. 648, ten years prior to its decision in *Trevor.*

94 California General Corporation Law s. 413 (Compact ed. West 1986); New York Business Corporation Law s. 628(c) (McKinney 1986).

95 Companies Act 1985 (U.K.) ss. 144-149.

96 For instance, where shares are issued to a nominee or acquired by a nominee from a third party as partly paid up, then for all purposes the shares are treated as held by the nominee and the company has no beneficial interest. Ibid., s. 144(1). However, this rule is not applicable to shares acquired (other than by subscription) by a nominee of a public company with financial assistance; the company has a beneficial interest in such shares. Ibid., s.145(1). Where the shares acquired by the nominee (whether through issuance or transfer) were only partially paid and the nominee fails to meet a call within 21 days, then depending upon the circumstances, the other subscribers or the directors are personally liable. Ibid., s. 144(2).

repurchases, on a proportional basis, a fixed percentage of shares each year from its members. In other cases, capital gains treatment is more appropriate: for instance where a shareholder's interest is liquidated under a greenmail or buy-out agreement. A tax regime should, at a minimum, contain rules to distinguish between these two types of distribution in order to facilitate business planning and to prevent erosion of the tax base.

Although the tax regimes of the United States and the United Kingdom differ in some fundamental respects, their treatment of repurchase transactions is strikingly similar. Amounts distributed in reacquisition of shares (whether by redemption or repurchase) are taxed as dividends (in the United States only to the extent of earnings) unless the statute provides otherwise.[97] Both regimes exempt from this rule, and tax as capital exchanges, qualifying repurchases which result in a sufficiently disproportionate reduction of the vendor's interest or which occur in order to fund an estate tax liability.[98] Finally, both regimes contain elaborate rules for attributing share ownership as between family members and related entities.[99] The long list of qualification criteria under the English scheme will subject some transactions to dividend treatment which would be accorded capital gain treatment in the United States; the wider scope of the attribution rules in the United States statute will produce more favourable treatment in other situations. The application of these rules may yield unexpected results in even relatively simple cases.[100]

These rules of English and United States tax law regulate repurchase transactions undertaken by closely held private companies. Both systems treat as capital dispositions, at least in respect to the seller, repurchases by publicly listed companies over the sharemarket. This acknowledges the fact that in such transactions the seller knows neither the identity of the buyer nor that the sale proceeds are in fact a distribution of company profits. In the United Kingdom, which has adopted an integrated system of taxation for company profits, any repurchase constitutes a potentially 'qualifying distribution' for which the company must pay advance company tax.[101] In the United

97 Under U.S.A. tax law, the distribution is deemed to be comprised of: first, a taxable dividend (to the extent the company has current or retained earnings); second, a tax free return of capital (i.e., the subscription price of the shares); and third, a capital gain taxable at a concessionary rate if the share was held for longer than one year. 26 U.S.C.A. ss. 301(a), 301(c), 316(a) (West 1978). Under the U.K. regime, the order of characterisation depends upon as yet unresolved ambiguities in the relevant statute. I.C.T.A. 1970 (U.K.) ss. 232(1) (Sched. F), 233(2)(b). See Bramwell, Ivory & Brannan, *Taxation of Companies and Company Reconstructions* (3d ed. Sweet & Maxwell, London 1985) at 156-159, 202-206 (repurchase proceeds are a taxable distribution to the extent that the price exceeds the original issue price) and *Simon's Taxes* (rev. 3d ed., Butterworths, London, 1984) at D2.506-D2.507.

98 26 U.S.C.A. s. 302 (West 1978); Finance Act 1982 (U.K.) s. 53 and Sched 9; Statement of Practice 2/82.

99 26 U.S.C.A. ss. 302(c), 304, 318(a) (West 1978); Finance Act 1982 (U.K.) Sched. 9 ss. 14, 15.

100 For English law, see discussion of hypothetical cases by Wyatt, *Company Acquisition of Own Shares* (Oyez Longman, London, 1983) at 55-74. For U.S.A. law, see the intuitively surprising results in *U.S.* v. *Davis* 397 U.S. 301 (1975), *Fehrs Finance Co* v. *C.I.R.* 487 F. 2d 184 (8th Cir. 1973) and *Fehrs* v. *U.S.* 556 F.2d 1019 (Ct. Cl. 1977).

101 Finance Act 1972 (U.K.) s. 84.

States, which lacks such an integrated system except for small companies electing to be taxed as partnerships, the repurchase has no effect other than possibly to reduce the company's earnings and profits, the measure for determining the dividend component of a future distribution.[102]

While English and American tax laws distinguish between repurchase *qua* dividend and repurchase *qua* exchange in an intuitively appealing way, their common approach suffers two fundamental flaws. First, to the extent that the law treats on-market repurchases by publicly traded companies as an exchange, it invites these companies to substitute repurchase for dividend distribution. Second, and more fundamentally, the law ignores the composite nature of the repurchase transaction: repurchase amounts to distribution of a dividend to one group of shareholders who then use the money to purchase the holding of the other shareholders. Taxed in accordance with this view, a repurchase should result in dividend recognition by the remaining shareholders and capital gain by the retiring shareholder.[103] This approach makes largely unnecessary the complicated rules for distinguishing between repurchase as a dividend and repurchase as a capital disposition. As applied to open market repurchases by publicly listed companies, it prevents circumvention of the rules normally applicable to taxation of company profits. Finally, it provides equivalent tax treatment for repurchase transactions and the cash — or — share dividend arrangement which has gained recent popularity and is, in many respects, financially equivalent to a repurchase transaction.[104]

XIII. CORPORATE GOVERNANCE

Repurchase of own shares affects corporate governance both *ex ante* (legal authorisation for repurchase) and *ex post* (impact of repurchase upon allocation of authority between members and management). Some statutes empower companies to repurchase shares simpliciter. Other statutes confer such power only if authorised by the memorandum or articles. Still other statutes confer such power unless prohibited by the memorandum or articles.[105] As regards the exercise of the power, some statutes leave the decision wholly to management, others require advance shareholder approval for some or all types of repurchase.[106]

102 26 U.S.C.A. ss. 301(c)(1), 316(a) (West 1978).

103 See Chirelstein, supra, n. 16 at 749-752.

104 A given change in ownership participation can be achieved either: (a) by repurchasing the shares of members wishing to reduce their holdings; or (b) by declaring a cash-or-share dividend on which these shareholders accept the cash alternative and the others accept the share alternative; see Chirelstein, ibid., at 753-754.

105 For examples of each approach see, respectively, Delaware General Corporation Law s. 160; Companies Act 1985 (U.K.) s. 162(1); Canada Business Corporations Act 1974-75-76 (Can.) c.33 s. 32(1).

106 See, e.g., Companies Act 1973 (British Columbia) s.256 and Delaware General Corporation Law s.160 [repurchase decision with management]; Companies Act 1985 (U.K.) ss. 164(2), 166(1), 173(2) [shareholder resolution required].

Statutes which empower companies to repurchase shares without regard to anything in the memorandum or articles avoid the anomalies associated with the ultra vires doctrine. Shareholders, creditors and investors should not have to inspect the company's memorandum or articles to determine whether or not a particular sale of shares or distribution (usually of profits) is within the company's power. In the case of publicly listed companies, the conferral of such power simpliciter would appear to be one of those aspects of share ownership which, in order to enhance cross liquidity of investment, should be subject to standardisation, although this uniformity can be imposed either by statute or by listing requirement. Whilst private companies should, like partnerships, enjoy the freedom of contract to choose whether or not to repurchase equity units, a grant of power simpliciter leaves them free to make this choice in the individual case.

More controversial is the role of shareholder involvement in the decision to exercise the repurchase power in the individual case. Simultaneously a distribution of assets (usually of profits) and a reorganisation of ownership participation, repurchase occupies an ambiguous place in the traditional scheme of corporate governance which put distributions of profit primarily under the control of management and required shareholder approval for reorganisations of ownership. Most recent North American enactments leave the repurchase decision entirely with management, although one proposed greenmail statute requires shareholder approval for any targetted repurchase above three percent.[107] In contrast, the new English statute requires advance shareholder approval for a wide range of repurchase transactions.[108]

Although the English approach accords with traditional notions of corporate democracy, it comes as a high cost and is of doubtful efficacy. To be effective, shareholder approval must be informed. The English statutory programme for repurchase and the going-private statutes in the United States and Canada[109] illustrate the extremes of what might be considered as adequate informational basis for a shareholder decision. The delivery of such information subjects repurchase to delays and transaction costs which detract from its utility, particularly in takeover contests where speed and surprise are often essential.

As a more fundamental matter, there is reason to doubt whether shareholder approval makes more than a nominal contribution to corporate democracy. In the case of private companies, where management is either identical with or generally responsive to shareholder concern, such a requirement is superfluous. In the case of publicly held companies, most shareholders are concerned only with dividend policy and the share price performance. This apathy and the high cost of organising a proxy contest enable management, with the support of 15-20% of the shareholders, to control the outcome of

107 See in addition to references idem and Note, supra, n. 54, American Bar Association, Model Business Corporations Act 1979 s. 6.

108 Companies Act 1985 (U.K.) ss. 164(2), 166(1), 173(2).

109 Cp. Companies Act 1985 (U.K.) ss.164, 166 with Canada Business Corporations Act 1974-75-76 (Can.) c.33 ss. 187-198 and 17 C.F.R. s.240. 13e (U.S.A.).

even those decisions requiring supermajority approval. In short, the various legislative approaches to legal authorisation for repurchase raise matters of high principle but little real substance.

Of far greater significance are the effects of repurchase upon corporate governance *ex post*. Since repurchase usually changes ownership participation, it alters the existing allocation of authority between management and members. Through repurchase of own shares, management can use company assets to determine the composition of the shareholders and thus the outcome of the voting process. This impact is the acknowledged objective of greenmail, going private and buyout transactions. It is also, from management's view, a not undesirable side effect of repurchase programmes aimed at maintaining a share inventory. Further, the offer to repurchase — whether it be made by management or shareholders — is more or less coercive.[110] At best, in the case of open tender repurchase, it forces shareholders to choose between two equally unacceptable alternatives: they may participate in profits and relinquish their shares or foreswear the distribution and increase ownership participation. At worst, in the case of a targetted repurchase, the decision leaves the mass of shareholders only with the latter alternative. This use of company assets subverts the statutory scheme of corporate governance, contravenes the expectations of most investors, places management in a severe conflict of interest and, according to most studies does not enhance the market value of the firm. The court in *Trevor* was quick to recognise these dangers and held that even the special exigencies involved in managing a quasi partnership could not justify this use of corporate funds.[111]

XIV. CONCLUSION

Experience abroad with regulation of repurchase of own shares contains several lessons for the New Zealand legal community. Once the rule in *Trevor* is abolished, the United States experience indicates that repurchase will become a major use of corporate assets. Companies will make extensive use of repurchase for such diverse ends as massaging balance sheet ratios, facilitating the retirement of members in closely held private companies, administering employee share schemes and implementing or defeating take-over bids. Although local companies can accomplish these objectives by resort to existing institutions of New Zealand company law, with all due respect to the Jenkins Committee, the availability of these alternative routes does not justify continued adherence to the rule in *Trevor*. Resort to the circuitous alternatives not only raises the costs of achieving the objectives, it also obscures the financing and governance of companies for creditors, shareholders, prospective investors and law enforcement agencies.

Experience abroad also demonstrates that repurchase of own shares, deployed for whatever objective, invites practices which have been perceived as highly abusive. Due

110 Supra, text following n. 16.

111 (1887) 12 App Cas. 417-418 (per Lord Herschell); 424, 430 (per Lord Watson); 435, 438 (per Lord Macnaghten).

to the tripartite nature of repurchase, these abuses span the entire range of corporate chicanery and include: share price manipulation; insider trading; over reaching; management entrenchment; conflict of interest; breach of fiduciary obligation; discriminatory treatment of shareholders and misuse of corporate assets. These practices, since they are not necessary incidents of repurchase, admit to regulation short of prohibition. On the other hand, necessarily and in all deployments, repurchase contains a coercive element in that it short circuits the normal portfolio management decision. Targeted repurchases force shareholders to increase their ownership participation and pro rata repurchases force shareholders to choose between two possibly unacceptable alternatives. This feature is inherent in the repurchase transaction in the sense that it cannot be eliminated by any means short of an absolute prohibition.

Reform of the rule in *Trevor* should in theory seek to change the law in such a way that enhances total social welfare. In a world defined by certain economic models, it is often although not always clear which rules will promote or impede the achievement of this objective. In the real world, however, there is no way to verify, either *ex post* or *ex ante*, whether a particular allocation of resources is efficient or whether one allocation is more efficient than another. What can be verified is that rules promote the welfare of certain groups at the expense of other groups. In considering whether to regulate repurchase of own shares, Parliament should consider who will benefit and lose from the use of repurchase, e.g., to manipulate share prices, to exploit inside information, to expropriate future profits by internal takeover, and to entrench management. These are all practices which, in the experience abroad, are sure to occur. All surveyed jurisdictions which permit repurchase have chosen, for reasons having more to do with fairness than economic efficiency, to surround repurchase with regulations which limit the extent to which repurchase can be used to reallocate wealth in the manners implied by these practices.

Should New Zealand decide to follow this route, experience abroad presents it with two regulatory alternatives. In Canada and United States, the company law permits repurchase subject only to the simple and uniform solvency constraint applicable to all non liquidating distributions. The objectionable abuses are curtailed by extending to repurchase pre-existing institutions of company and securities law. These range from a liberal regime governing derivative actions to extensive financial reporting requirements. The alternative approach is that of the recent English legislation which establishes a more or less self contained regime which seeks to minimise the most deleterious consequences of repurchase for corporate governance and finance.

Unfortunately perhaps, neither of the regulatory alternatives is possible in New Zealand. New Zealand law is bereft of the institutions which in the United States and Canada balance the interests of companies and their managers on the one hand and minority shareholders and unsecured creditors on the other. Whilst reform of New Zealand law governing such matters as take-overs, insider trading, floating charges and financial reporting may be long overdue, it makes little sense to key its implementation to a single transaction such as repurchase of own shares. The English regulatory

alternative, imposed by Council directives, originates in a regulatory environment (primarily that of European Community law) completely foreign to New Zealand and presumes a level of professional expertise which may well lie beyond the competence of even the relatively sophisticated English bar and commercial community.

The Companies Act 1955 follows a statute which was not only wholly inappropriate for the then pastoral economy but one which largely ignored the competing social interests in the society from which it issued. A half century of benign neglect or deliberate truculence has left New Zealand with a company law regime so rudimentary by contemporary standards that it cannot readily absorb corporate transactions of proven utility in a way that accommodates the diverse economic and social interests implicated by those transactions.