Companies: Capital Reductions versus Share Buy-Backs

A company's share capital is the total amount of money the shareholders have provided to the company in consideration for the shares issued to them.

A company is required to maintain its share capital as part of the principle of limited liability, so a creditor dealing with a limited liability company can ascertain the amount of the company's share capital by searching the public registers. It follows that a company cannot freely reduce its share capital, as this would prejudice creditors.

Provided that it does not materially prejudice a company's ability to pay its creditors, two methods under the *Corporations Act 2001* (Cth) (**Act**) allow a company to reduce its share capital:

1. a share capital reduction; and
2. a share buy-back.

Under a share capital reduction, any money paid to a company in respect of a member's share is returned to the member. Capital reductions can also occur when certain shares are cancelled for nil consideration. A share buy-back, on the other hand, is when a company acquires shares in itself from existing shareholders, and then cancels these shares.

Capital Reduction

A reduction in share capital occurs when any money paid to a company in respect of a member's shares is returned to the member.

Authorised share capital reductions

Section 256B of the Act provides that a company may reduce its share capital if the reduction:

(a) is fair and reasonable to the company's shareholders as a whole;

Level 2, 111 Wellington Street, East Perth WA 6004 • PO Box 6314, East Perth WA 6892
T: +61 8 9388 3100 • F: +61 8 9388 3105 • E: reception@murfett.com.au
ABN 74 120 362 825 • W: www.murfett.com.au

(b) does not materially prejudice the company's ability to pay its creditors (although note that this doesn't apply if the shares are cancelled for nil consideration); and
(c) is approved by shareholders under section 256C of the Act.

There are two main types of capital reduction: equal and selective. **Equal reduction** is when the reduction relates only to ordinary shares, applies to each holder of ordinary shares in proportion to the number of ordinary shares held and, as the name suggests, the terms of the reduction are the same for each member. If any of the above does not apply, then it is a **selective reduction.**

Requires shareholder approval

An equal reduction requires **shareholder approval** by way of ordinary resolution whereas a selective reduction must be approved by either a special resolution (with certain voting restrictions), or a resolution agreed to by *all* ordinary shareholders.

Notify ASIC before and after reducing share capital

The company must **notify ASIC** of the reduction in share capital before the shareholders' meetings are called, it must notify ASIC of changes to the company's share structure after the reduction has taken place, and, in the case of a selective reduction, the Company must provide ASIC with a copy of the resolution passed by the shareholders.

Share Buy-Backs

Section 257A of the Act provides that a company may buy-back its shares if:

(a) the buy-back does not materially prejudice the company's ability to pay its creditors; and
(b) the company follows the provisions of Part 2J.1 Division 2 of the Act.

There are a number of different categories of share buy-backs, including:

1. Equal access, where all ordinary shareholders are offered a reasonable opportunity to consider the offer to buy-back the same percentage of their ordinary shares;
2. Selective buy-backs, where non-identical offers are made to members, for example buy-back offers are only made to some of the members of the company;
3. Employee share scheme buy-backs, when a company may buy-back shares held by or for employees or salaried directors of the company;
4. On market buy-backs, where listed companies can buy-back their shares in the ordinary course of trading on the stock exchange; and
5. Minimum holding buy-backs, where listed companies buy-back unmarketable parcels of shares from shareholders.

The rights attaching to the shares are suspended when a company enters an agreement to buy-back the shares. Once the shares are bought back, the company must cancel them.

Shareholder approval may be required

A selective buy-back must be approved by all members or by a special resolution of members in which no vote is cast by the "selling" member. Other share buy-backs generally require the approval by an ordinary resolution only if they exceed the 10/12 limit of 10% of the smallest number at any time during the last 12 months of votes attaching to voting shares of the company.

Notify ASIC

Wherever shareholder approval of the buy-back is required, copies of the notices and related material must be lodged with ASIC before the shareholders meeting and in all buy-backs, companies must notify ASIC of the cancellation of the shares following the share buy-back.

So what is the difference?

Practically, the effect of both a share capital reduction and share buy-back is a reduction in the share capital of the company.

What distinguishes a share buy-back from share capital reduction is that the member decides whether or not to accept the company's offer to buy-back the shares. In contrast, with a share capital reduction once the relevant shareholder approval has been given, the reduction may affect shareholders that did not vote on, or voted against, the resolution.

The tax consequences for shareholders will also be different under a share buy-back than those arising under equal or selective capital reduction.

For further information contact Murfett Legal by telephone on +61 8 9388 3100, via our website at www.murfett.com.au or email one of the following directors:

Jason De Silva : jason.desilva@murfett.com.au

Kelly Parker : kelly.parker@murfett.com.au

Peter Broun : peter.broun@murfett.com.au