MEMO

To: Board of Directors

From: Company Secretary

Subject: **CANCELLATION OF SHARES**

Simply put, a company is formed by investors applying for shares, so that its initial 'balance sheet' is an 'asset' of cash of $X and 'shareholders funds' (share capital) of the same amount. Thereafter, as the business grows, 'shareholders funds' increase, primarily through profits earned and additional share issues.

In the normal course, once a company is no longer needed, it can be wound up and the 'shareholders funds' can be distributed back to the investors.

The Corporations Act generally restricts the ability of a company to reduce its shareholders funds (by cancellation or otherwise) prior to being wound up, primarily to protect creditors and, to some extent if relevant, other/remaining shareholders.

However, the Act does make provision for 'early' reduction of share capital/cancellation of shares in certain circumstances/situations, with the process allowed under the Act designed to:

(a) minimise the risks of such action leading to the company's insolvency
(b) ensure fairness between stakeholders
(c) require the company to disclose all material information.

A company (generally) may cancel its shares only in one of two ways:

- **share capital reduction**,

or

- **share buy-back**

although there are some other ways specifically covered in the Act, but not as commonly utilised.

A share capital reduction means, subject to shareholder approval, the mandatory cancellation of a number of shares (even of those who are against the capital reduction) and sometimes, but not always, payment to shareholders. On the other hand, with a share buy-back, payment is made to shareholders, but they are not obliged to sell (and of course they then receive no payment from the company).

Share Capital Reduction

A reduction in a company's share capital occurs when any money paid to a company to acquire shares is returned to the shareholder and the relevant shares are cancelled. However, it can also occur when no monetary payment or other consideration is made to shareholders but some shares are cancelled because there is no longer a need for such shares.

A share capital reduction is allowed if it:

(a) is fair and reasonable to the shareholders as a whole
(b) does not materially prejudice the company's ability to pay its creditors; and
(c) is approved by shareholders under sec.256C of the Act.

All 3 conditions must be satisfied before the reduction can proceed. And once approved all shareholders are obliged to participate, even if they do not want to.

A reduction can be either:

(i) an equal reduction (applies to the same proportion of shares and on the same terms, for each shareholder);

or, in any other case:

(ii) a selective reduction.

Shareholder approval is required to approve the share capital reduction (by ordinary resolution if 'equal' and special resolution if 'selective') but the cancellation of the shares must be by a special resolution passed by the shareholders whose shares are to be cancelled.

The first step in the process is a directors' meeting/resolution to call an Extraordinary General Meeting for shareholders to consider the capital reduction.

'Meeting documents' comprising a Notice of Meeting and an Explanatory Memorandum are then prepared. The Memorandum must set out all information that is material to the shareholders' decision. And depending on the circumstances – perhaps to minimize any creditor 'backlash' – it may be prudent to obtain an independent expert's report concluding that the proposal is 'fair and reasonable'.

Share Buy-back

The other main way of effecting a cancellation of shares is through a “buy-back”.

A “buy-back” involves a company reclaiming issued shares by purchasing them back from existing shareholders.

The main types of share buy-back are:

- equal access
- selective
- on-market or minimum holding (stock exchange listed companies).

Within these types different rules apply where 10% or less of the total shares are purchased within a 12 month period (‘10/12 limit’), compared to greater than 10%.

The 10/12 limit procedures are set out in sec.257B(4) & (5) of the Act.

(a) Equal Access

This is the most straight forward buy-back method. All shareholders are given an identical offer to sell the same percentage of their shareholding back to the company.

If the buy-back is within the 10/12 limit then no shareholders approval is required; otherwise shareholders must pass an ordinary resolution to approve the buy-back. In either case shareholders are not obliged to sell.

(b) Selective

In broad terms, in a selective buy-back is one where identical offers are not made to every shareholder. In fact, the buy-back may only involve 1 shareholder in some circumstances.

A selective buy-back requires the approval of all shareholders, or a special resolution (75%) passed by those shareholders who are not participating in the buy-back.

The 10/12 limit does not apply to a selective buy-back.

Other Cancellations

Other permitted share cancellation methods include:

(a) Share Forfeiture

A company may cancel shares that have been forfeited under the terms on which they were issued, subject to receiving shareholders approval (sec.258D).

(b) Redeemable Preference Shares

A company may reduce capital through the redemption of redeemable preference shares, which may be done out of profits or the proceeds of a new issue of shares made for the purposes of the redemption (secs.254J & 258E).

(c) Other situations

These relate, for example, to an unlimited company (which can reduce capital in any way it chooses), 'lost' capital (no longer represented by assets), and extinguishment of uncalled liability on partly-paid shares