



MEMO

To: Board of Directors
From: Company Secretary
Subject: **REDUCTION IN SHARE CAPITAL – PRIVATE COMPANY**

You have requested advices on how we, as a Proprietary Limited (Pty Ltd) company, can 'remove' the 40 or so shareholders not 'connected' to the directors, who only control about 15% of the company's shares, so that the company can be run as a real 'private' company.

A company may reduce its share capital, generally speaking, only in one of two ways:-

- Share buy-back; or
- Share capital reduction.

In summary, I do not think a 'share buy-back' is the way to go because shareholders are not compelled to accept whatever offer [for their shares] is made to them.

Share Capital Reduction

The way to go then is through a reduction in the company's share capital, effected by the company paying back to shareholders all or a portion of the capital originally paid up to the company to acquire the shares, then the relevant shares are cancelled.

A share capital reduction can also occur when no monetary payment or other consideration is given to shareholders but their shares are cancelled because there is no longer a need for such shares.

Unless otherwise specifically covered by the Corporations Act, a share capital reduction is allowed under sec.256B(1) 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.

Mandatory Participation

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*. Some say this could advantage/disadvantage some shareholders over others – but the question may be: which ones? Case law indicates that any such claims have only been upheld where it was shown that the cancellation was not '*fair and reasonable to the shareholders as a whole*'.



A reduction can be either:

- (i) an equal reduction; or
- (ii) a selective reduction.

An equal reduction applies to each holder of ordinary shares in proportion to the number of shares they hold and the terms of the reduction are the same for each shareholder. A selective reduction is where any of these criteria do not apply – sec.256B(2).

Selective Reduction

For us the answer is a ‘selective reduction’ in share capital, directed only at the ‘non-connected’ shareholders (ie, those not ‘connected’ to the directors).

Shareholder approval is required to approve the reduction (by ordinary resolution if ‘equal’ – unless the company’s constitution otherwise requires – and special resolution if ‘selective’) and, if the reduction also involves the cancellation of shares, by a special resolution passed by the class of shareholders whose shares are to be cancelled.

Shareholders’ Meeting

First step in the process is a directors’ meeting/resolution to convene an Extraordinary General Meeting (EGM) for shareholders to consider the capital reduction.

Because of our shareholder numbers an EGM will probably be necessary, although I point out that because we are a Pty Ltd company we could, if we wanted to, just send around a circulating resolution for shareholders to sign – as allowed under sec.249A.

‘Meeting documents’ comprising a Notice of Meeting (NOM) and an Explanatory Memorandum (Memo) are then prepared. The Memo must set out all information that is material to the shareholders’ decision.

Information for Shareholders

Sec.256C(4) explains that the information to accompany a NOM must set out all information known to the company that is material to the decision on how to vote – in a Memo.

See below list of suggested matters to be covered in the Memo (based on what is required under Regulatory Guide 110 for a share buy-back). In addition, case law indicates that an Independent Expert’s Report is probably required to satisfy sec.256C(4) – in particular as regards whether the proposed share capital reduction is considered fair and reasonable to all shareholders.

This information will also assist creditors in assessing any implications the share capital reduction may have for them.



Voting

At the EGM the [selective] capital reduction must be approved – sec.256C(2) – by:

- (a) special resolution (ie, at least 75% of all classes of shareholders present in person or by proxy, attorney or representative) – with any votes *in favour* by any shareholder participating in the capital reduction *not counted*; **or**
- (b) resolution agreed unanimously by all *ordinary* shareholders.

Sec.256C(2) also has what might be described as a footnote that says: “If the reduction involves the cancellation of shares, the reduction must also be approved by a special resolution passed at a meeting of the shareholders whose shares are to be cancelled.”

This can be considered a little unclear, particularly as a share capital reduction effectively must include a cancellation of shares. However, in practice, a separate ‘class meeting’ is called say immediately before the general meeting [which will approve the share capital reduction] to formally approve the cancellation – although this may depend a little on how the resolutions are worded as to the share capital reduction/share cancellation sequence.

ASIC Notifications

Form 2560 “Notification of Reduction in Share Capital Details” must be lodged with ASIC, with a copy of the meeting notice and accompanying documents, at least the day before [the date of] the notice convening the shareholders’ meeting is despatched.

For a selective reduction only, Form 2205 “Notification of Resolution Regarding Shares” with a copy of the approved resolution must be lodged with ASIC within 14 days after the shareholders’ meeting, but the actual share capital reduction does not take effect until 14 clear days after lodgement date.

Form 484 “Change to Company Details” (Section C1 Cancellation of Shares) must be lodged within 28 days of the actual share capital reduction date to effect the return of capital in ASIC’s records and effect any share cancellation (sec.254Y). Note too as a Pty Ltd company that the requirements of sec.178A~D with regard to information to be provided on the Form 484, in particular any impact on the ‘top 20’ shareholders, must also be complied with.

Suggested Information in Memo

There is no prescribed information or particulars to be included in the Memo or other documentation to assist shareholders in voting for a share capital reduction. However, at a minimum, it is suggested that the following information should be provided to ensure compliance with sec.256C(4):



- (a) the number of shares on issue;
- (b) the number and percentage of shares to be cancelled;
- (c) particulars of the terms of the cancellation;
- (d) the amount being paid or a simple formula to calculate the price;
- (e) the reasons for the share capital reduction;
- (f) the interests of any director who may participate in the capital reduction;
- (g) the financial effect of the capital reduction on the company;
- (h) the source of the funds for the capital reduction;
- (i) the effective date of the share capital reduction;
- (j) for a selective capital reduction, the effect it will have on the control of the company;
- (k) for a selective capital reduction, details of the shareholders affected;
- (l) for a selective capital reduction, the advantages and disadvantages of approving the reduction;
- (m) the company's most recent financial statements.

DISCLAIMER

The comments in this memo reflect some commercial aspects and observations on the matter experienced or observed by the writer in practice as he understands them. The information is given as a guide only and does not represent a definitive or legal view of any of the issues raised, covered or referred to and the reader is urged to seek his own professional advice on all aspects of, or pertaining to, this and any related matter.