Business Law: CIMA Year One

Corporate Finance

Corporations can be financed either by shares or by debentures. A share gives ownership o part of the company to an individual. A debenture is a form of loan.

Shares

Shares carry with them a bundle of rights and duties:

- You buy a right to be a shareholder (which is intangible property).
- You buy a right to attend shareholders' meetings, to vote, and to receive dividends.
- You do not have an automatic right to take part in management.

Shares are normally issued with the intention of raising capital. Sometimes shares can be issued in return for assets instead of cash – this is called "non-cash consideration".

The <u>authorised or nominal share capital</u> is the amount of capital the company is registered with, and is listed in the Memorandum of Association. This is the total of the nominal amounts written on each share. To change the authorised share capital, a special resolution must be passed.

The <u>issued share capital</u> is the amount of the authorised share capital which has been issued. This may not be equal to the authorised share capital if the company as retained some shares. It represents the funding a company has received from its members.

The <u>called-up share capital</u> is the total amount which has been called up from shareholders. If shares do not have to be paid immediately, directors may chose when finance can be called from shareholders.

The <u>paid-up share capital</u> is the total amount which has been paid. The difference between called-up and paid-up share capital is the amount owing from shareholders, which is often zero. Any references to 'capital' in a company's accounts or business letters must refer to paid-up capital.

Types of share

Different types of share have different rights. A shareholder is given a share certificate as evidence that they have a certain number of shares. Actual ownership of shares depends on the company's official register of shareholders.

<u>Ordinary shares</u> carry a right to vote, but have no fixed dividend. The majority of shares in public companies are ordinary shares. Any dividend paid on ordinary shares is determined at

the AGM. In addition, when a company is liquidated, if any money is left after all creditors have been paid and shares have been redeemed, then this is shared between ordinary shareholders.

Preference shares do not normally carry a right to vote, but do command a fixed dividend. This dividend takes preference over the dividend paid to ordinary shareholders; that is, when the dividend is decided at the AGM, any dividend due to preference shareholders is removed from consideration. If there is not enough profit to pay preference dividends, generally they are considered cumulative, so any money owing on them is due the next year in addition o the next year's dividends.

Deferred shares do not generally command a dividend at all until preference shareholders have been paid and ordinary shareholders have received a certain amount. If the dividend paid to ordinary shareholders is below this limit, deferred shareholders receive no dividends. These are uncommon.

Redeemable shares can be ordinary or preference shares. These contain a clause that the company is able to buy back the share at some point in the future. The price which will be paid (or a formula to calculate this) must be specified at the time of issue, as well as a time period during which redemption may take place.

Stock exists where companies have converted paid-up shares into a monetary amount instead of a number of shares.

Each of these types of share can be termed a 'class'. Shareholders' meetings can involve just one class if it is deciding on actions which only affect that class.

Debentures and Loans

Debentures featured in Salomon v Salomon & Co Ltd. When S had sold his business to S&C, it had been paid for in cash, shares and a loan of £10,000. This loan of £10,000 was considered as a liability to S&C, and when S&C folded, the loan was repaid since S was a priority creditor.

When a company looks to increase its capital through debentures, the lender does not buy shares in the company but instead lends money in return for an interest payment. This interest payment is not dependent on profits, and lenders will normally evaluate the business for security to ensure that interest will be paid. If security is low, a lender will normally charge higher interest rates.

Note that there are a few differences between debentures and shares:
- Debentures must be repaid at some specified point in the future.
- Loan lenders do not gain voting rights in the company.

- Dividends are dependent on profit, while interest is not.
- Dividends are dependent on the decisions of directors and shareholders, while interest is not.
- Shares vary in value depending on the success of the company, whereas debentures have a fixed value.
- Companies may obtain tax relief on interest but not on dividends.
- Debentures are most appropriate for short-term borrowing.
- Directors need little authority to increase capital through debentures.

There are two types of debenture: those secured by a fixed charge and those secured by floating charge.

Fixed charge debentures

The security here is some specific, identifiable property, and the property (normally an asset) is restricted in use. For example, if the loan is a mortgage, then the building may not be sub-let. The restriction is generally on allowing companies to give third parties right to use their assets, since this will affect the lender's security.

It is not sufficient for a debenture contract to merely state that the loan is secured over a fixed charge; the lender must enforce the restrictions placed down.

Floating charge debentures

For a debenture secured over a floating charge, the charge is a *class of assets*, which may vary over time. For example, a lender may secure his loan over aluminium stocks at a drinks can factory. Note that this can cause issues when looking at finished goods, if stocks are low.

If a company folds, then its classes of assets "crystallise" – that is, they are frozen at a particular point, and any debenture secured over that class of assets becomes a fixed charge debenture. Charges will crystallise when:

- A company passes a voluntary winding-up order
- A court petitions for the company to be wound up
- The court appoints a receiver
- Creditors appoint a receiver
- Interest payments on the debenture are missed

Generally, when a company is wound up, any debenture secured over a fixed charge is repaid before debentures secured over floating charges. Furthermore, any preferential creditors will be paid first, along with landlords' rent completed, judgement creditors, owners of goods supplied on hire-purchase agreements, and owners of goods supplied under Romalpa clauses.

Romalpa Clauses

In the early 1980s, UK industry was failing and interest rates were high. Any organisation supplying goods to industry wanted security that they would be paid. A Romalpa clause (or 'reservation of title' clause) ensures that ownership of any goods is not transferred until they are paid for, so if the industrial company failed, the supplier could reclaim the goods.

> Aluminium Industrie Vaasen BV v Romalpa Aluminium Ltd (1976)
> AIV supplied RA with stocks of aluminium. RA went into administration, and AIV claimed their stocks back. The contract document contained the following:
> *The ownership of the material to be delivered by AIV will only be transferred to purchaser when he has met all that is owing to AIV, no matter on what grounds. Until the date of payment, purchaser, if AIV so desires, is required to store this material in such a way that it is clearly the property of AIV … AIV and purchaser agree that, if purchaser should make (a) new object(s) from the material, mixes this material with (an)other object(s) or if this material in any way whatsoever becomes a constituent of (an)other object(s) AIV will be given the ownership of this (these) new object(s) as surety of the full payment of what purchaser owes AIV.*
> The courts held that the stock were the property of AIV and should be returned.

Such contracts are not registered, but the consensus is that they can hold and take precedence over any debentures since the company never owned the stock in order to offer security on it.

Registration of charges

Companies must keep a register of all charges on their property. In addition:

- Most charges must be registered with the Registrar of Companies. This does not apply to charges when the creditor is entitled to non-cash returns, such as the possession of goods.
- Any mortgages (that is, charges secured over property) must be registered with the Land Registry. This stops lots of building societies lending money secured on the same house.

Trust deeds

When a lot of people wish to invest in one large loan, it can be difficult to coordinate negotiations between the lenders and the borrowing company. Instead, a trust is set up and one nominated trustee negotiates on behalf of all lenders. This trustee has a legal obligation to act in the best interests of all lenders.