

BOARD OF TRADE

**Report of the  
Company  
Law Committee**

*Presented to Parliament by the President of the Board of Trade  
by Command of Her Majesty*

*June 1962*

LONDON

HER MAJESTY'S STATIONERY OFFICE

PRICE 12s. 6d. NET

Cmnd. 1749

SJSJ SYDNEY LIB.

Dated this 5th day of January, 1960

The President of the Board of Trade was on the 10th day of December, 1959, pleased to appoint the undermentioned persons to be a Committee to review and report upon the provisions and working of the Companies Act, 1948, the Prevention of Fraud (Investments) Act, 1958, except in so far as it relates to industrial and provident societies and building societies, and the Registration of Business Names Act, 1916, as amended; to consider in the light of modern conditions and practices, including the practice of take-over bids, what should be the duties of directors and the rights of shareholders; and generally to recommend what changes in the law are desirable:

THE RIGHT HONOURABLE LORD JENKINS (*Chairman*)

MR. FREDRICK RUDOLPH ALTHAUS

MR. ERIC ALBERT BINGEN

MR. LESLIE BROWN, F.I.A.

SIR GEORGE ERSKINE, C.B.E.

PROFESSOR LAURENCE CECIL BARTLETT GOWER, M.B.E.

MR. WILLIAM HALFORD Lawson, C.B.E., F.C.A.

MR. JAMES ALEXANDER LUMSDEN, M.B.E.

MR. KENNETH WULSTON MACKINNON, Q.C., M.B.E., T.D.

MRS. MARGOT NAYLOR

MR. GORDON WILLIAM HUMPHREYS RICHARDSON

MR. CHARLES HILARY SCOTT

MR. RON SMITH

MR. WILLIAM WATSON, C.A.

The President was further pleased to appoint MR. PETER EUSTACE THORNTON to be Secretary to the Committee.

iii

## TABLE OF CONTENTS

	Paragraph
INTRODUCTORY	1
CHAPTER I: THE FORMATION AND POWERS OF COMPANIES	
General	20
Conditions of Incorporation	
Minimum membership	21
Minimum number of directors	25
Minimum paid up capital	27
Registration fees	28
Other matters	29
Recommendations	31
No Par Value Shares	32
Recommendations	34
The Company's Objects and Powers - Ultra Vires	35
Recommendations	42
The Company's Objects and Powers - Other Matters	
Common form powers	43
Pre-incorporation contracts	44
Alteration of objects	45
Charitable and political donations	50
Recommendations	54

## CHAPTER II: CLASSIFICATION OF COMPANIES

Exempt Private Companies	55
Recommendations	63
Distinction between Private and Other Companies.	64
Recommendations	67
Miscellaneous matters	
Change from limited to unlimited liability	68
Section 19 companies and companies limited by guarantee	69
"Incorporated partnerships"	71
Partnerships	76
Recommendations	78

## CHAPTER III: DIRECTORS

Appointment and Tenure of Office	79
Recommendations	85
Duties of Directors	
General	86
Directors' share dealings	88
Compensation for loss of office	92
Disclosure of directors' other interests	94
Loans to directors	98
Recommendations	99

Paragraph

Directors' Powers and Shareholders' Control

General	100
Information to shareholders	114
Disposal of assets	117
Issue of shares	119
Recommendations	122

CHAPTER IV: OWNERSHIP AND CONTROL OF COMPANIES

Shares with Restricted or No Voting Rights	123
General	137
Designation Notice of meeting	138
Recommendations	140
Disclosure of Share Ownership	141
Recommendations	147
Subsidiary and Associated Companies	
Definition of subsidiary company	148
Section 27	151
Recommendations	156

CHAPTER V: REDUCTION OF CAPITAL AND THE PURCHASE BY  
A COMPANY OF ITS OWN SHARES

Reduction of capital	157
----------------------	-----

Share premium	161
Purchase by a company of its own shares	167
Section 54	170
Recommendations	187

## CHAPTER VI: MINORITIES

Protection of Special Classes of Shares	188
Recommendations	198
Protection of Minorities	199
Recommendations	212
Board of Trade's Powers to Appoint Inspectors	213
Recommendations	218

## CHAPTER VII: THE PROTECTION OF INVESTORS

General	2129
Recommendations	234
Prospectuses	
Definition	235
Applications and allotments	238
Information to be given	243
Broadcast and cinematograph advertising	246
Statement in lieu of prospectus	247
Certificates of exemption	249
Registration of prospectuses	251
Recommendations	252



## Dealing in Securities

General	253
Stock exchanges and recognised associations of dealers	256
Exempted dealers	258
Licensed dealers	261
Investment advisers	263
Recommendations	264
Take-over Bids	
General	265
Take-over bids and employees	267
The present system of control	268
Proposed new system of control	270
Powers of Board of Trade	272
Circulars recommending rejection	273
Procedure	274
Information to be given in take-over circulars.	280
Minority shareholders - compulsory acquisition right to be bought out	283
Recommendations	294

## CHAPTER VIII: LOAN CAPITAL

Register of debenture holders	295
Model debenture trust deed	297

Enforcement of securities - powers and liabilities of receivers.	298
--	-----

Registration of charges	300
-------------------------	-----

Recommendations	306
-----------------	-----

## CHAPTER IX: UNIT TRUSTS

General	307
---------	-----

Proposed new system of control	311
--------------------------------	-----

Managers and trustees	316
-----------------------	-----

Information for unit holders	317
------------------------------	-----

Control of managers' charges	319
------------------------------	-----

Inspectors	322
------------	-----

Cancellation of registration	323
------------------------------	-----

Powers of the Board of Trade	324
------------------------------	-----

Unit trusts formed overseas	325
-----------------------------	-----

Open-ended investment companies	326
---------------------------------	-----

Investment clubs	328
------------------	-----

Recommendations	329
-----------------	-----

## CHAPTER X: ACCOUNTS

General	330
---------	-----

Distribution of Profits	
-------------------------	--

General	335
---------	-----

Distribution of unrealised capital surplus	336
--	-----

Previous capital and revenue losses	340
-------------------------------------	-----

Pre-acquisition profits	342
Depreciation	349
Recommendations	350

	Paragraph
Exemption for Unquoted Companies	351
Recommendations	352
Balance Sheet: (1) Fixed Assets	
Valuation	353
Investments	363
Realisation of investments and treatment or profits	366
Capital expenditure	367
Distinction between fixed and current assets	368
Recommendations	
Balance Sheet: (2) Other Matters	
Stocks	370
Issued capital, reserves, provisions' and liabilities	371
Disclosure of companies' shareholdings	375
Unclaimed dividends	379
Recommendations	380
Profit and Loss Account	
Income	381
Items of expenditure	383
Taxation	384
Auditors' remuneration	391
Profits of the year	392

Turnover, summary of past results, interim reports	393
Recommendations	397
Exemption of Banks, Discount Houses, Insurance and Shipping Companies	
General	398
Banks and Discount Houses	
General	399
Definition of banks	405
Recommendations	407
Insurance companies	408
Recommendations	412
Shipping companies	413
Recommendations	416
Exempting power	417
Recommendations	418
Miscellaneous provisions	419
Recommendations	423
CHAPTER XI: AUDITORS	
Qualifications	424

Appointment and removal	427
Powers	431
Form of auditor's report	432
Recommendations	435

## CHAPTER XII: BUSINESS AND COMPANY NAMES

Business names	436
Company names	448
Change of a company's name	454
Disclosure of names of company directors	455
Recommendations	456

## CHAPTER XIII: COMPANY MANAGEMENT AND ADMINISTRATION

Meetings	457
General meetings	458
Extraordinary general meetings	459
Requisitions.	460
Quorum at meetings	462
Resolutions	465
Proxies	468
Notices and circulars relating to meetings	457
Recommendations	458
Location of Statutory Books	469
Recommendation	470

## Share Transfer and Registration Procedure

General	471
Shares and stock	472
Delayed share transfers	475
The share register	477
Preservation of documents	481
Liability of companies for certification of transfers	482
Recommendations	483

#### Returns to the Registrar of Companies

General	484
Annual return - list of members	485
Annual return - charges	486
Particulars of directors.	487
Return of allotments - section 52	489
Filing of additional information	492
Form of documents delivered to the Registrar of Companies	493
Functions of the Registrar	494
Recommendations	495

#### CHAPTER XIV: WINDING UP

General	496
Directors of insolvent companies	497
Receivers and managers	501

Miscellaneous	502
Recommendations	503

# CHAPTER XV: ENFORCEMENT OF THE LAW AND OTHER MATTERS

## Problems of Administration and Enforcement of the Law

General 504

Recommendations 511

## Foreign Companies and Other Matters

Foreign companies 512

Other matters 523

Recommendations 525

Conclusion 526

## NOTES OF DISSENT:

Shares with Restricted or No Voting Rights 207

Accounts of Banks and Discount Companies 211

## APPENDIX:

A. Memorandum issued to certain Organisations and Individuals 217

B. Organisations and Individuals who gave Oral Evidence before the Committee	221
---	-----

Note. The estimated cost of this Report is £31,790 of which £3,444 represents the cost of printing and publishing the Report and £5,506 represents the cost of printing and publishing the evidence. Of this latter sum £2,850 has so far been recovered from sales.

## REPORT OF THE COMPANY LAW COMMITTEE

The Rt. Hon. Frederick Erroll, M.P.,  
President of the Board of Trade.

1. We were appointed by your predecessor on the 10th December. 1959

"To review and report upon the provisions and working of the Companies Act, 1948, the Prevention of Fraud (Investments) Act, 1958, except in so far as it relates to industrial and provident societies and building societies, and the Registration of Business Names Act, 1916, as amended; to consider in the light of modern conditions and practices, including the practice of takeover bids, what should be the duties of directors and the rights of shareholders; and generally to, recommend what changes in the law are desirable."

2. We now have the honour to submit our Report.

3. In response to personal invitations and advertisements in the Press we received a substantial body of written evidence bearing upon the matters under review from individuals, companies, Government departments and trade and professional organisations concerned in one capacity or another with the operation of this branch of the law: in all more than 300 memoranda or letters were received. At our request the written evidence contributed was, to facilitate collation, for the most part arranged in accordance with headings listed in a standard form of questionnaire provided by us, which now appears in Appendix A to this Report. In many cases the written evidence submitted was supplemented by oral evidence, which, with the written evidence to which it referred, was printed and published as our enquiry proceeded (Minutes of Evidence taken before the Company Law Committee and published by Her Majesty's Stationery Office). The names of the witnesses who gave oral evidence are listed in Appendix B. The evidence both written and oral has been of the greatest

possible assistance to us and we would here record our indebtedness to all those who took part in providing it. Our special thanks are due to the distinguished witnesses from the U.S.A.:

Mr. Manuel F. Cohen, Director. Division of Corporation Finance, Securities and Exchange Commission (now a Commissioner of the Securities and Exchange Commission),

Professor Louis Loss, Law School, Harvard University,

Mr. Henry S. Morgan. Mr. John M. Young and Mr. Frank A. Petito, of Morgan Stanley & Co., New York,

Mr. George A. Brownell and Mr. Frederick A. O. Schwarz, of Davis Polk Wardwell Sunderland and Kiendl, New York.

Mr. C. D. McDaniel of Arthur Andersen & Co.,

for coming here to give evidence and for the remarkably lucid and interesting account they gave us of American law and practice.

4. We held in all 20 meetings of the Committee at which oral evidence was given by or on behalf of contributors of written evidence and 44 meetings of the Committee or of working groups for purposes of discussion.

## **Introduction**

5. During the 100 years since the passing of the Companies Act, 1862 later enactments have greatly increased the volume and complexity of the law relating to companies; and the Act of 1948, the provisions of which we are now called upon to review, comprises the formidable total of 462 sections and 18 Schedules.

6. We would gladly see a reduction in this unwieldy mass of legislation but have not found it possible to make suggestions contributing to that end to more than a very limited extent. This elaboration of the law can generally speaking be fairly justified as having been found necessary in order to keep effective control over the growing and changing uses of the company system as an instrument of business and finance and the possibilities of abuse inherent in that system. It would be wrong in principle to disturb in any important respect long-standing provisions designed to serve these ends unless they have clearly outlived their usefulness or are demonstrably objectionable on other grounds. It therefore appears unlikely that the dimensions of any new Act (after allowing for our own recommendations so far as adopted) will in the end prove substantially less than those of the Act of 1948.

7. It is generally agreed that the amendment and consolidation of the law effected by the Companies Acts of 1947 and 1948 improved in many important respects the law as it previously stood under the Companies Act, 1929, and that the consolidated provisions now embodied in the Companies Act, 1948 have on the whole worked well in practice over the years which have elapsed since the passing of that Act.

8. Indeed some witnesses have been inclined to question the need for, or desirability of, further changes of major importance in a system found by experience to have worked reasonably well. We regard this as a salutary frame of mind in which to approach proposals to alter the existing law in any significant respect: and generally speaking we accept the principle that it must be for those who claim that the law should be altered to make out their case.

9. We cannot, however, accept the view that the Act of 1948 has left no room for further improvements of substance in the law as it now stands. This is not a field of legislation in which finality is to be expected. The law here falls to be applied to a growing and changing subject matter, and the number and variety of the suggestions submitted by our witnesses clearly show that there are many questions, of sufficient importance to merit legislative attention, left unresolved by the Act of 1948, or arising out of its provisions, or out of events occurring since it was passed.

10. In the chapters which follow we consider and discuss the main suggestions we have received, with others which have emerged in the course of our discussions, and (subject to what is said in paragraph 18 below)

recommend the adoption in any new Act of those which it would in our view be both practicable and desirable to adopt.

11. It is no doubt necessary for the protection of shareholders, creditors and intending investors that the activities of companies and those responsible for their management should be subject to a considerable degree of statutory regulation and control. But controls and regulations carried to excess may defeat their own object; and we share the views expressed by the Greene and Cohen Committees as to the undesirability of imposing restrictions which would seriously hamper the activities of honest men in order to defeat an occasional wrongdoer, and the importance of not placing unreasonable fetters upon business which is conducted in an efficient and honest manner.

12. Accordingly, in our consideration of proposals to impose further statutory restrictions and requirements on companies or their directors, we have asked ourselves whether the new restriction or duty proposed would, if it was made law, improve to an extent worthy of legislation the position of the investors or creditors it was designed to protect; and if so whether its implementation would to any significant extent hamper or impede the company in the efficient conduct of its legitimate business, thus perhaps operating to the detriment of those very persons.

13. Thus, while (for example) we share the views of the Cohen Committee as to the importance of ensuring that companies should make available to shareholders, creditors and the general public as much information as is reasonably required, we also recognise the importance, where the desirability of some proposed new statutory obligation to provide information is in question, of considering whether the additional information would be of any real value to the persons receiving it, and if so whether its ascertainment would involve an amount of work disproportionate to its value, or its publication might be detrimental to the company's business, and thus indirectly to its shareholders and creditors.

14. Another instance of conflicting considerations is to be found in proposals for giving shareholders closer control over their directors. It may be theoretically desirable that shareholders should have a more effective voice in the management of their company's business, of which they are the ultimate proprietors. As against this, no company's affairs can be managed properly, or indeed managed at all, otherwise than through a board of directors with a reasonably free hand to do what they think best in the interests of the company. The risk (which must not be exaggerated) that dishonest directors may abuse the trust reposed in them must be accepted if business is to go on.

15. In the chapters which follow we have discussed and made recommendations upon many aspects of company law of varying public and professional interest. The more important of these include exempt and non-exempt private companies, nominee shareholdings and take over bids. Under exempt and non-exempt private companies the main question for our consideration was whether the exemptions from filing accounts, etc., accorded to exempt private companies by the Act of 1948 should be preserved; and we have recommended that they should be abolished.

Under nominee shareholdings there was strong support for the, introduction of some new scheme for disclosure of beneficial interests in shareholdings which, it was hoped, would not attract the same criticism as the scheme propounded in the Cohen Report, and we have recommended accordingly.

16. As regards take-over bids, it was made clear to us that our terms of reference limited the field of our inquiry to the duties of directors and the fights of shareholders affected by such bids. We have therefore confined our recommendations to this limited field and have refrained from embarking on an examination of the broader economic and social questions which have been raised in relation to some recent bids.

17. No useful purpose would be served by prolonging this introduction with a full discussion of the many other matters on which we have made recommendations or expressed views below: but we may perhaps mention that those of some general interest include: (a) shares of no par value which if our recommendation is accepted will be introduced as recommended in the Gedge Report of 1954 with the addition of preference shares; (b) voteless shares on which our majority recommendation is against abolition. (c) the protection of minorities, on which we have recommended amendments of section 210 of the Act of 1948 designed to make it more effective and easier to invoke; and (d) our recommendation that consultation and co-operation between the Board of Trade and other organisations concerned with the protection of investors should be further developed.

18. The width of our terms of reference has made it imperative in order to keep our enquiry and this Report within manageable bounds that our recommendations should be to some extent selective. This we have sought to achieve by limiting our actual recommendations, so far as we could conveniently do so, to matters of major importance and listing and sending to the Board of Trade minor points concerning procedure, drafting and so forth which, though calling for attention, would be more suitably dealt with by the Board in the course of the preparation of any new legislation.

19. We have not attempted to clothe our recommendations in statutory language because if any of them find their way into a new Act this will no doubt be done by others better qualified.

## CHAPTER I

### THE FORMATION AND POWERS OF COMPANIES

20. At the end of 1961 the total number of companies on the English and Scottish registers was 403,000 of which some 16,000 were public companies and the remainder were private companies. The annual registration of new companies has increased very substantially since 1948, and particularly since 1958, as the following figures show:

1948	16,300
1955	17.500
1958	22,400
1959	29.200
1960	34,300
1961	33.600

The Board of Trade have referred in their evidence to the irresponsible multiplication of companies, particularly of "one-man" companies; to the dangers of abuse through the incorporation with limited liability of very small, under-capitalised businesses; and to the fact that incorporation is nowadays frequently used as a cheap means of protecting a name and for various other purposes than carrying on an undertaking or business in association with others. In this connection, a sample analysis made by the Board at our request indicated that 20 per cent, of all private companies registered in 1954 had by mid-1961, gone into liquidation or had been struck off the register or were seriously in default in filing returns. We are satisfied that this proliferation of very small companies can and does lead to abuse and gives rise to ever-increasing administrative difficulties, and should, if possible, be checked without making it unduly difficult for genuine small businesses to incorporate with limited liability. We make a number of proposals below which we think might achieve this purpose.

## Conditions of Incorporation

### *Minimum membership*

21. The Companies Act at present requires public companies to have a minimum of seven members and private companies a minimum of two members. Some witnesses have proposed that the requisite minimum should be one for all companies, public and private, or at all events for private companies. This proposal is founded on the contention that as the requisite minimum membership is commonly made up by the use of a nominee or nominees and as the so-called "one-man" company has been held to be legal ever since *Salemen's Case*, the time has come for the law to be brought into line with reality by giving statutory sanction to the ability to form and carry on a company which a single individual in substance enjoys at present. We recognise the force of these arguments but in our view

the practical advantages of making the change are insufficiently great to justify the consequential alterations of existing law and practice. Especially is this so in the light of our later recommendation that every company should have at least two directors and that the first two subscribers to the memorandum should be deemed to be directors unless and until the Registrar is notified of others. This recommendation is designed to discourage irresponsible incorporations; and a change which would enable one man, by merely signing a piece of paper and complying with certain statutory requirements, to convert himself into a company and to repeat this performance as often as he wishes, might be thought to encourage them. We appreciate that in some cases, for example in that of the wholly owned subsidiary, one subscriber and member will continue to be a mere nominee, but even in the case of a wholly owned subsidiary this helps to draw attention to the fact that it is a separate corporate entity and not a mere department of the holding company.

22. On the side of increasing the minimum membership we have had it put to us that the minimum in the case of a private company should be increased to three with a view to facilitating administration on death and regular management as regards meetings, etc. It seems to us that this would be a sensible plan for the majority of private companies, but it might well be inconvenient for others and should not therefore, in our view, be made a statutory obligation. We have made certain other recommendations in paragraph 31 (c) and (e) below which we hope may help to deal with this problem.

23. Further, it has been suggested that there is no need for the present difference between the minimum membership for a public company (seven) and that for a private company (two). and that the minimum for all companies should be put at the lower figure. This suggestion is based partly on the apparently pointless nature of the distinction - the quoted public company will in any event have many more than seven members, and there seems to be no good reason for the distinction in this respect between other public companies and private companies; and partly on the practice now common of forming companies in the first instance as private companies and subsequently converting them into public companies if desired, avoiding by this expedient the necessity for at least seven subscribers to the memorandum (and the requirements of

sections 109, 130 and 181). We regard this suggestion as making for simplicity without detriment to anyone and therefore as worthy of adoption. We should add that it accords with the proposals which we make later in this Report for the abolition of all special provisions now applicable to private companies.

24. Section 222 (d) provides that the Court may wind up a company if the number of members is reduced below the statutory minimum, and section 224 (1) enables any creditor or contributory to make the requisite application. We think that, additionally, the Board of Trade should have power to apply to the Court for the winding up of a company in such circumstances.

#### *Minimum number of directors*

25. The Companies Act at present provides that a public company registered on or after 1st November, 1929, shall have at least two directors

and that other companies including private companies, shall have a director (section 176). We think that the problems arising on the death of a sole director might, as some witnesses have suggested, be met by making it obligatory for every company to have at least two directors. We consider that a minimum requirement of two directors might also help to check the present state of irresponsible incorporations of "one-man" companies to which we have already referred. Unlike the nominee appointed merely as second member of a "one-man" company, the second director would have clear responsibilities and obligations and might therefore be less likely to accept the appointment without due care. Employees are sometimes now appointed as second members and we recognise that, if our proposal is adopted, some employees may be pressed in future to accept appointment as second directors without being informed of the responsibilities which this involves. This risk should, in our view, be accepted: the remedy is a wider realisation of the fact that the office of director carries responsibilities as well as prestige. To reduce the difficulties of enforcement we suggest that the Act should provide that the first two subscribers to the memorandum of association shall be deemed to be directors unless until the company notifies the Registrar of the names of at least two directors.

26. We believe that it would also be convenient to provide that, for the purposes of section 135 (power of Court to order meeting), personal representatives of deceased shareholders, who if living would have been entitled to vote at the meeting, should be treated as members: this would enable the company to appoint directors when all directors and shareholders had died.

#### *Minimum paid up capital*

27. At present there is no statutory requirement of a minimum paid up capital. Some witnesses have expressed the view that under-capitalisation is a major cause of business failures and that a statutory minimum capital, paid up in cash, would prevent the launching of at least some under, capitalised companies. Others have argued that while such a provision might be desirable in principle it would be relatively easy to evade. They have suggested that it would be difficult, if not impossible, to prevent a company, once formed with a statutory

minimum of cash, from returning the cash to the promoters either in exchange for assets, such as goodwill, or by way of a loan, or in some other way. Although we would favour in principle a statutory minimum paid up capital we have reluctantly come to the conclusion that its purpose would be too easy to evade and we cannot, therefore, recommend it.

#### *Registration fees*

28. The Twelfth Schedule to the Act provides that a fee of five shillings shall be paid to the Registrar for registering documents, with certain exceptions, and for making a record of any fact (e.g. a change of directors) required or authorised to be recorded by the Registrar. Section 98 (1) requires payment of such fee as may be specified by regulations made by the Board of Trade (at present ten shillings or one pound according to the amount secured) for entries in the register of charges. A single annual registration fee in replacement of these various fees would be a consider-

able administrative convenience. If this new registration fee were moderately large and were coupled with a substantial initial registration fee it would, we believe, help to check the spate of irresponsible incorporations. We hope that it would also lead to the removal from the register of moribund companies, freeing space in the Registrar's office and company names for others, particularly if, as we recommend in Chapter XV below, the Registrar were empowered to apply to the Court for the company to be wound up or struck off the register if the annual fee were not paid within a stated period. We suggest that the minimum initial registration fee should be of the order of £25 (in place of the present minimum of £2) and that the Twelfth Schedule should be correspondingly adapted. We suggest, that the annual fee (in replacement of the various fees charged for registering documents, etc.) should be of the order of £5. We think that fees of this magnitude are necessary to achieve the objectives mentioned above. If they produce more than the cost of administering the Companies Registration Office we nonetheless regard them as the minimum necessary. If, on the other hand, they produce less than the cost of such administration (after taking into account receipts for searches by the public) an increase sufficient to meet the deficiency should be made.

#### *Other matters*

29. Our attention has been drawn to anomalies and deficiencies both in the provisions relating to the adoption of model articles and to the model articles themselves, particularly Table C, which relates to companies limited by guarantee and having to share capital, We have passed the detailed criticisms to the Board of Trade for consideration when a new Bill is being drafted.

30. Finally it has been suggested to us, and we agree, that the statutory declaration required by section 15 (2) no longer serves a useful purpose.

31. **We recommend that:**

(a) the minimum membership for all companies should be two;

(b) the Board of Trade should have power to apply to the Court to wind up a company whose membership is reduced below two;

(c) section 176 should be amended to provide that every company should have at least two directors within, say, six months after a new Companies Act has been enacted; a penalty should be introduced for failure to comply with section 176 as amended, with a proviso that, where the number at directors falls below two by reason of the decease or retirement of one or more directors, the company should have a reasonable period within which to restore the number to two;

(d) the new Act should provide that the first two subscribers to the memorandum of association of a company incorporated after its entry into force should be deemed to be directors unless and until the company notifies the Registrar of the names of at least two directors;

(e) section 135 should be amended so that personal representatives of deceased members should be treated, for the purposes of that section, as members of the company, with the same voting rights as the deceased members;

(f) an initial minimum registration fee of, say, £25 should be imposed;

(g) an annual registration lee of, say, £5 should be imposed on every registered company, in replacement of existing fees for the registration of documents, etc.;

(h) the statutory declaration required by section 15 (2) should no longer be required.

### **No Par Value Shares**

32. We have received no evidence against, and much in favour of the introduction of no par value ordinary shares. The only matter on which significant differences of opinion have been expressed by witnesses is whether or not no par value preference shares should be permitted. The Gedge Committee summarised their views on this in paragraph 40 of their Report:

"It may be said that there is no objection in principle to the extension of the system of shares of no par value to preference capital. The evidence on this matter is divided, and on balance we have come to the conclusion that the system should be confined to ordinary share capital. We feel that a fixed dividend must have a relation to the sum on which it is paid, and that that, as well as the repayment of a fixed sum in a winding up, is out of keeping with the concept of no par value."

33. On the other hand, where the rate of interest is liable to considerable changes over relatively short periods, as it has been in recent years, par value preference shares may be misleading to the uninitiated investor. If 4 per cent, £1 preference shares are issued at par and the market rate of interest then rises to 6 per cent., the market value of the shares will, be substantially less than par and the annual return to an investor buying at the later date will be

correspondingly greater than the 4 per cent, with which they are labelled. On this ground alone we think companies should be permitted to issue no par value preference shares if they wish to. But they have other advantages. For example, a company might wish to issue blocks of no par preference shares at different dates (when different rates of interest are ruling) which may all rank *pari passu*. A no par preference share offering £5 per annum can be issued at £100 (with priority for £100 in winding up) when the market rate of interest is 5 per cent. and at, say, £95 (with priority for £100) when the rate of interest has risen. Thus over a period of years a company is enabled to issue, at different prices, a single class of no par preference shares instead of a series of classes of par value preference shares carrying different percentage returns. This is not only convenient for the company but brings the advantage of a bigger total issue, and a wider market in the shares, to the shareholders.

**34. We recommend that the Companies Act should be amended to allow the Issue of preference and ordinary shares of no par value and that the consequential changes in the law which the Gedge Committee recommended, should apply, subject to certain modifications suggested in paragraphs 166 and 345 below, to preference as well as ordinary shares.**

### **The Company's Objects and Powers - Ultra Vires**

35. The nature and effect of the ultra vires doctrine in relation to companies incorporated under the Companies Act, 1948 and its predecessors are concisely stated by the Cohen Committee in this passage from paragraph 11 of their report:

"The memorandum of a company defines its objects and a company's objects are limited to those expressly mentioned and such as are ancillary to the expressed objects. A contract made by the directors upon a matter not within the ambit of the company's objects is *ultra vires* the company, and, therefore, beyond the powers of the directors. This principle is intended to protect both those who deal with the company, and its shareholders."

36. In paragraph 12 the Cohen Committee went on to refer to the practice "of drafting memoranda of association very widely and at great length so as to enable the company to engage in any form of activity in which it might conceivably at some later date wish to engage and so as to confer on it all ancillary powers which it might conceivably require in connection with such activities" and concluded that "in consequence the doctrine of *ultra vires* is an illusory protection for the shareholders and yet may be a pitfall for third parties dealing with the company"; and that "as now applied to companies, the *ultra vires* doctrine serves no positive purpose but is, on the other hand, a cause of unnecessary prolixity and vexation." The remedy proposed by the Cohen Committee for this unsatisfactory state of affairs was that "every company ... should, notwithstanding anything omitted from its memorandum of association, have as regards third parties the same powers as an individual"; and that "existing provisions in memoranda as regards the powers of companies, and any like provisions introduced into memoranda in future should operate solely as a contract between a company and its shareholders as to the powers exercisable by the directors". In conjunction with this proposal the Cohen Committee expressed the view that "it would then be a sufficient safeguard if such provisions (i.e. provisions in memoranda as regards the powers of companies taking effect 'solely as a contract between a company and its shareholders as to the powers exercisable by the directors') were alterable by special resolution without the necessity of obtaining the

sanction of the Court", subject to provisions for the protection of the holders of debentures issued before the coming into force of a new Act.

37. By section 5 of the 1948 Act (to which we will later refer) qualified effect was given to the Cohen Committee's recommendations as to the alteration of objects clauses by special resolution without the sanction of the Court; but nothing was done to implement their recommendation as to the abolition of the *ultra vires* doctrine.

38. The memorandum of evidence submitted by the Board of Trade in the present inquiry gives the following reasons for this omission:

"When the Bill amending the 1929 Act was being prepared, the Board were advised that it would not be a simple operation to give effect to this suggestion of the Cohen Committee. A third party might find himself unable to enforce a contract against a company either on the ground that it was outside the scope of the company's objects or on the ground that it was beyond the authority of the directors. In both cases he would be affected with notice

of the limits imposed by the objects clause of the company's memorandum, which was a public document. Merely to abrogate the *ultra vires* rule in relation to the company would in practice leave the third party no better off, since the objects clause would still affect him with notice of the limits on the authority of the directors. Nor would it be likely to reduce the prolixity of modern memoranda, since directors would have a strong incentive to protect themselves by procuring the company to extend the authority given them by the objects clause. To give effect to the suggestion of the Cohen Committee it would therefore be necessary to modify, if not to abrogate, the rule that the memorandum is a public document, of which third party dealing with the company are deemed to have notice. In view of the prevailing pressure of work and the need for rapidly implementing the main recommendations of the Cohen Committee, the Board decided that they would not be justified in holding up the preparation of the Bill in order to work out what appeared to them to be a far-reaching change which might involve highly complicated drafting."

It seems to us that the difficulties which weighed with the Board of Trade on the last occasion are equally serious today.

39. To re-state the problems involved:

(i) Those who favour the abolition of the *ultra vires* principle seek to achieve their object by legislation to the effect that notwithstanding anything contained in or omitted from its memorandum of association every company is to have as regards third parties all the powers of a natural person.

(ii) But a company not being in fact a natural person can only act through directors or other agents exercising powers delegated to them by the company.

(iii) What, then, is the extent of the delegation to be? The company could (apart from legislation to the contrary) presumably adhere to the plan now usual of making by its

articles an "omnibus" delegation of its powers to its directors.

(iv) The position then would be that the company would have all the powers of a natural person, and that these powers (with the usual statutory exceptions, which are not material for the present purpose) would be exercisable in their entirety by the directors.

(v) Would not this state of affairs place too much power in the hands of the directors? Present complaints regarding the state of company law are often to the effect that shareholders should be given greater and more effective control over the activities of directors. From this point of view the omnibus delegation to the directors of all the powers of a natural person conferred on the company by the proposed legislation would seem to us a retrograde step.

(vi) Moreover, would not investors and creditors and the public at large justifiably wish to know what activities the company was pursuing or presently intending to pursue within the ambit of its all-embracing powers of a natural person, and to have some particulars as to existing or proposed activities in some public document available for inspection?

(vii) Once it is accepted that some limit is to be set upon the extent of the powers delegated to the directors, how is it to be done? The Cohen Committee's plan was in effect to make the objects clause operate only as between the shareholders and the company, by way of definition of, or limitation upon, the powers of the company exercisable by the directors. If this were done, would not the third party be fixed with notice of the objects in their new guise, and of the limitations which they imposed, in accordance with the general rule that anyone dealing with a company is deemed to have notice of its public documents? Would not *ultra vires* difficulties creep in again, as it were on a lower level? Would not the third party be concerned to see that the directors were not exceeding their delegated powers? And would not the directors on their part be concerned to see that the objects clause stated the scope of their delegated powers with the greatest possible width and particularity (incidentally leaving objects clauses as prolix as they are today)?

(viii) Thus the third party if fixed with constructive notice of the extent of the director's delegated powers would be little better off under the new law than he was under the old. If on the other hand the new law absolved him from notice, would the objects clause in its new guise afford any protection to the shareholders? We doubt if it would.

(ix) To give complete protection to the third party it would be necessary to absolve him not only from constructive, but also from express, notice of any limitation upon the directors' delegated powers: In other words he would have to be deemed not to know things which he actually did know - a legislative expedient which seems to us highly undesirable.

40. Difficulties such as these lead us to conclude that the change in the law involved in the proposed attribution to companies of all the powers of a natural person ought not to be lightly adopted, and we see no sufficiently cogent reason for adopting it. The evil sought to be cured is the injustice wrought to third parties who have entered into and acted on contracts with a company which are afterwards discovered to be *ultra vires* the company. This source of injustice, however, has been to a great extent eliminated by the use of the wide forms of objects clause referred to in the Cohen Committee's report, and instances in which injustice has in fact been

brought about by the *ultra vires* rule seem of late years to have been rare, the most recent example cited to us being that of *In re Jon Beauforte (London) Ltd.* [1953] Ch. 131.

41. In these circumstances it seems to us that the best course will be to attempt no general repeal of the existing law of *ultra vires* in relation to companies registered under the Companies Acts but to provide protection to third parties contracting with companies (i) against the unfair operation of the *ultra vires* rule and (ii) by abrogating the rule, already mitigated by the decision in *Royal British Bank v. Turquand*, (1855) 5 E. & B. 248, (1856) 6 E. & B. 327, that third parties are fixed with constructive notice of the contents of a company's memorandum and articles of association.

42. We recommend that:

(a) a contract entered into between a company and another party (including a shareholder contracting otherwise than in his capacity as a shareholder) contracting with the company in good faith should not be held invalid as against the other party on the ground that it was beyond the powers of the company: he should not, however, be allowed to enforce the contract without submitting to perform his part of it so far as it is unperformed;

(b) in entering into any such contract the other party should be entitled to assume without investigation that the company is in fact possessed of the necessary power; and should not by reason of his omission so to investigate be deemed not to have acted in good faith, or be deprived of his right to enforce the contract on the ground that at the time of entering into it he had constructive notice of any limitations on the powers of the company, or on the powers of any director or other person to act on the company's behalf, imposed by its memorandum or articles of association;

(c) the other party should not be deprived of his right to enforce the contract on the ground that he had actual knowledge of the contents of the memorandum and articles at the time of entering into the contract if he honestly and reasonably failed to appreciate that they had the effect of precluding the company (or any director or other person on its behalf) from entering into the contract in question;

(d) there should be no change in the position of a company in relation to ultra vires contracts entered into by it.

#### The Company's Objects and Powers - Other Matters

*Common form powers*

43. Section 2 of the Act requires the memorandum of association of every company to state, *inter alia*, the objects of the company. In the case of many companies the bulk of the provisions contained in the objects clause set out what appear to be powers, such as the power to borrow money or to give guarantees, rather than objects. Many witnesses have criticised this practice, which is partly responsible for the inordinate length of many modern objects clauses. We suggest that the Act should be amended to provide (like the Companies Acts of some Commonwealth Countries) that every company should have certain "common form" powers, which should be expressly set out in the Act. The powers so set out should be, as nearly as possible, only those which oil companies normally need in order to attain their objects; they should be conferred upon all existing and future companies, but it should be made clear that the application of the new powers is subject to any provisions to the contrary (express or implied) in the memorandum of association of the company concerned for the time being in force. We do not think that the setting out of a number of common form ancillary powers in this way would add to the powers which a company already enjoys, since it would be intended only to list a number of things which a company may do incidentally to the carrying on of its main business activities as specified in the objects clause in its memorandum

of association. We believe a company has such powers already so far as they are incidental to the carrying on of its business. Nevertheless, we think there would be an advantage in enacting specifically certain powers which a company enjoys in the carrying on of its business, partly to remove any doubt that there might be and partly because we hope that such a statutory list of powers would result in memoranda of association being drafted in future in less prolix terms by the omission of many common form powers. We suggest that the Act should make it clear that the powers listed in this way should be merely ancillary powers exercisable in the course of carrying on a company's business, and not specific objects. Many existing memoranda of association, however, after setting out a lengthy list of objects and powers, contain a provision that each clause shall be construed as a separate and specific object. The House of Lords in the case of *Cotman v. Brougham* [1918] A.C. 514 held this practice to be effective although they severely criticised it. It has become so well established that it is probably too late to attempt to prohibit it, and, although we do not recommend that such a provision should be included in the statutory list of ancillary powers, it may be that many memoranda of association will include the provision that each separate object or power, whether contained in the memorandum of association or incorporated by reference from the list of powers in the Act, should be construed as a separate and specific object. To the extent that this would be so, there will be little change in the present position, but we hope that our suggestion may result in some simplification of the drafting of memoranda of association.

#### *Pre-incorporation contracts*

44. It frequently happens that a person engaged in forming a company has the company's notepaper printed and orders supplies thereon prior to the incorporation of the company. Under the present law, the company when formed cannot unilaterally adopt the resulting contracts, but must make a new contract with the parties concerned. (*Kelner v. Baxter* (1866) L.R.2 C.P. 174). The unsatisfactory position of a person contracting with another acting on behalf of a company not yet formed is shown by a recent decision in *Newborne v. Sensolid (Great Britain) Ltd.* [1954] 1 Q.B. 45. According to this case if the order was signed (as it normally would be), in the name of the company, the individual concerned adding his name as "director", he cannot sue or be sued on the

contract, which is a complete nullity. This may enable either the supplier or the company and those engaged in its formation, to refuse to honour their undertakings should a change in market conditions make it profitable for them to do so. We regard this as obviously undesirable. We also consider it anomalous that the enforceability of the contract should depend on subtle differences in the terminology employed; for example, if the order is signed not "X and Co. Ltd., X director" but "X director as agent for X & Co. Ltd.", it appears that X can sue or be sued on the contract (*Kelner v. Baxter*). We think that the Act should provide, as do some Commonwealth Acts, that a company may unilaterally adopt contracts which purport to be made on its behalf or in its name prior to incorporation and thereby become a party to the same extent as if the contract had been entered into after incorporation. We also think that, unless and until the company does so adopt such

contracts, the persons who purported to act for the company should be entitled to sue and liable to be sued thereon.

### *Alteration of objects*

45. As mentioned above, section 5 of the 1948 Act gives qualified effect to the second branch of the Cohen Committee's recommendation on *ultra vires*. The scheme of the section is to substitute for the special resolution confirmed by the Court, which was required for the alteration of a company's objects under section 5 of the 1929 Act, a special resolution taking effect without recourse to the Court, except in the event of an application for the alteration to be cancelled being made to the Court within a specified time, by a specified proportion of shareholders or members, or of holders of debentures issued before the 1st December, 1947, in which case the alteration is only to take effect in so far as it is confirmed by the Court.

46. By subsection (1) of section 5 of the 1948 Act, as by subsection (1) of the corresponding section of the Act of 1929, the power of alteration is limited to the seven cases listed in paragraphs (a) to (g) of the sub-section. Under the old procedure the confirmation by the Court of the alteration applied for involved a decision that it fell within one or other of the permitted cases. But, except in the event of confirmation by the Court in proceedings brought by objectors, the mere special resolution, which (in the absence of objection) is all the new system requires, involves no such decision, and accordingly its validity would, in the absence of some provision to the contrary, be exposed to attack at any distance of time on the ground that the alterations in question were not authorised by the Act. This point is boldly met by section 5 (9) of the Act which (to put it shortly) provides that the validity of an alteration of a company's objects shall not be called in question as unauthorised by subsection (1) except in proceedings taken for this purpose before the expiration of 21 days after the date of the relevant resolution.

47. The section has been criticised on the ground that there is no sufficient reason for limiting a company's power to

alter its objects to the seven cases authorised by paragraphs (a) to (g) of subsection (1) and it would indeed appear that this enumeration of authorised alterations, or its equivalent in earlier enactments, has had little effect except as a challenge to the ingenuity of company draftsmen seeking to bring particular alterations within the authorised range. Moreover it seems to us to be unsatisfactory that alterations not falling within the authorised cases should be capable of being validated merely by the circumstance that no one has challenged their validity within the period of 21 days prescribed by subsection (9).

48. We therefore think it would be better to do away with the list of authorised alterations altogether, and substitute for it in section 5 (1) a general power of alteration, by abandoning or restricting any existing object, or by adopting any new object which could lawfully have been included in the objects clause of the company's memorandum as originally registered. Acceptance of this proposal would make it appropriate to repeal subsection (9).

49. It has also been suggested:

(i) that a provision should be inserted in section 5 requiring the company to cause notice of the meeting to pass the special resolution to alter the objects to be sent to all members, whether or not entitled to such notice under the company's articles of association. This seems to us to be only reasonable, as otherwise members not entitled to notice under the articles might not be aware of the proposal to alter the objects, and thus be deprived of their right to apply to the Court;

(ii) that the minimum proportion (15 per cent.) of shareholders (by shares held), members, or debenture holders required under section 5 (2) to support an application to the Court under section 5 (1) is too high. We agree that a person with a grievance should not be prevented from making an application through failure to get the support required to make up a prescribed minimum proportion so large as 15 per cent, but would not wish the proportion required to be so small as to encourage vexatious applications. We consider therefore that the minimum proportion should be reduced to 5 per cent, in each case;

(iii) that a nominee or trustee, who casts his votes in favour of a proposed alteration on behalf of some beneficiaries but against the alteration on behalf of others, should be able to apply to the Court on behalf of the latter. The proviso to section 5 (2) appears as it now stands to preclude this: we think, however, that the proviso is unnecessary and that it could safely be repealed;

(iv) that the period of 21 days from the date of the resolution altering the objects allowed by section 5 (3) for making an application to the Court under the section is too short. We agree on this point also, and think that the period should be increased to 28 days;

(v) that the Court should have power in its discretion to authorise the application of capital of the company in the

purchase of interests of dissentients, subject to the usual safeguards attending a reduction of capital. We see no sufficient reason for prohibiting this possibility, as is done in the proviso to section 5 (4).

*Charitable and political donations*

50. Evidence submitted to us on this subject has been largely confined to three matters:

(a) whether political donations by companies should be permitted;

(b) whether statutory powers should be conferred on every company (unless it provides to the contrary) to make charitable donations of every kind;

(c) whether such donations should be shown separately in the accounts.

51. One or two witnesses have suggested that companies should be prohibited from making donations for political purposes or to political organisations. It is not always clear whether it is intended simply that

donations to political parties should be prohibited or whether the prohibition is intended to extend to donations for a particular political purpose - for example, to oppose proposed legislation which might hamper or curtail a company's activities. We do not comment on the substance of these suggestions because we are quite clear that they are not primarily a matter of company law and that they raise constitutional issues which are outside our competence and which would affect other organisations besides companies.

52. If a company has express power, in its objects clause, to make charitable donations, then (subject to any express restriction imposed by the provision in question) its power to make any particular donation cannot be challenged (though the directors might be liable to account if the amount of such donations is unreasonable in the circumstances). If a company has no express power to make donations, it may nevertheless do so if they can reasonably be regarded as benefiting the company. This was established by *Evans v. Brunner, Mond & Co. Ltd.* [1921] 1 Ch. 359 where a donation for scientific research by Brunner, Mond & Co. Ltd., who were chemical manufacturers, was held to be *intra vires*. Since that case was decided in 1921 the practice, which has developed, of companies (without express powers) making donations to general charities of no direct interest to the companies' business has never been challenged in the Courts in this country and we venture to think that this practice, which is regarded by businessmen as necessary to create or preserve goodwill for their companies, would, on that ground, be acceptable to the Courts today.

53. It has been suggested that donations should be shown, in aggregate, in company accounts. We recognise that in some circumstances this information may be of interest to shareholders - and indeed, that if donations are relatively large the obligation (in section 149 (1)) to give in the accounts a true and fair view of the profit or loss of the company may now require their disclosure. But we do not think donations are a sufficiently important item in most company accounts to justify an express, general requirement to disclose them.

54. **We recommend that:**

(a) the Companies Act should be amended to provide that every company should have certain specified powers, except to the extent that they are excluded, expressly or by implication, by its memorandum; such powers being those which any company would normally need in order to pursue its objects;

(b) a company should be enabled unilaterally to adopt contracts which purport to be made on its behalf or in its name prior to incorporation, and thereby become a party thereto to the line extent as if the contract had been made after incorporation; until the company does so adopt such contracts, the persons who purported to act for the company should be entitled to sue and liable to be sued thereon;

(c) section 5 (1) should be amended in the sense indicated in paragraphs 48 and 49 (i) and section 5 (9) should accordingly be repealed;

(d) section 5 (2) should be amended by substituting "five per cent." for "fifteen per cent." wherever those words occur;

(e) the proviso to section 5 (2) should be repealed;

(f) section 5 (3) should be amended by substituting "twenty-eight days" for "twenty-one days";

(g) the proviso to section 5 (4) should be repealed.

## **CHAPTER II**

### **CLASSIFICATION OF COMPANIES**

#### **Exempt Private Companies**

55. Three types of company limited by shares are recognised in the present Act - exempt private companies, non-exempt private companies, and other companies, commonly known as public companies though there is no statutory definition of that term. In considering the distinctions in the Act in the treatment of these three types, we take first the exempt private company which enjoys substantial privileges compared with the other two.

56. Until the Companies Act, 1908, no companies were required to file accounts with the Registrar of Companies. That Act introduced the distinction between public and private companies and required the former but not the latter to file a statement in the form of a balance sheet. The Companies Act, 1948 introduced the further distinction between exempt and non-exempt private companies and required all companies other than exempt private companies to file accounts. The exempt private company, defined in section 129 (4) and the notoriously complicated Seventh Schedule of the Act, is not only exempted from the requirement as to the filing of accounts: it need not appoint a qualified accountant as auditor and may appoint as auditor a partner or employee of an officer of the company (provisos to subsections (1) and (2) of section 161): and it is not subject to the otherwise general prohibition, in section 190, against a company's making loans to its directors. It enjoys these privileges in addition to those accorded to non-exempt private companies, to which further reference is made below.

57. The Cohen Committee admitted that their proposed definition, which was broadly that adopted in the Act, of the exempt private company was complicated and would involve some anomalies, but they recommended its adoption as the best that could be devised to save the small family business from

disclosing its affairs to the public. Nevertheless we doubt whether the definition has worked out as the Committee or Parliament intended. Of the 387,000 private companies on the register at 31st December, 1961, some 269,000 (or 70 per cent.) had at that date claimed the status of exempt private company: experience suggests that a large proportion of the 33,000 companies registered in 1961 have not yet claimed exemption but will do so in due course - thus the proportion of all private companies which have claimed exemption or intend to do so is certainly much greater than 70 per cent. As the Board of Trade have pointed out to us, some of these exempt private companies are "not very small in membership or in capital or in the extent of their undertakings ". Moreover, the present definition is so complex that there is little doubt

that many companies, which at present claim and obtain exemption, are not entitled to it. The very complexity of the definition makes its application uncertain and produces unfair and capricious distinctions in the treatment of very similar companies. In this connexion and as examples of the complexity of the definition, we would refer to *Qualter Hall & Co, Ltd. v. Board of Trade* [1962] Ch. 273, and to *Re Prenn's Settlement: Truvox Engineering Co. Ltd. v. Board of Trade* [1961] 1 W.L.R. 569. We have been informed that the rest fit of this latter decision has been to exclude from exemption a considerable number of companies which have hitherto been thought by many practitioners to be within the statutory definition. Moreover it would, in our opinion, be very difficult to amend the Seventh Schedule so as simply to restore the position to what it was thought to have been before these decisions: such amendments would almost inevitably lead to still further widening of the scope of the Schedule.

58. In the evidence we have received about the exempt private company there has been very little support for the maintenance of the present exemptions in present of auditors and loans to directors. There is general agreement - except by certain associations of accountants not recognised under section 161 (1) (a) - that the accounts of all companies should be audited by accountants qualified under section 161 (1). The results of a sample inquiry conducted for us by the Board of Trade indicate that, subject to sampling errors, some 90 per cent. of all exempt private companies are now audited by such accountants and the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland have assured us that qualified accountants would be able to deal with the additional work involved if the present exemption were withdrawn. As regards loans to directors, the Cohen Committee did not recommend any exemption from a general prohibition. In paragraph 94 of their Report they said:

"We consider it undesirable that directors should borrow from their companies. If the director can offer good security, it is no hardship to him to borrow from other sources. If he cannot offer good security, it is undesirable that he should obtain from the company credit which he would not be able to obtain elsewhere."

We see no good reason for continuing the distinction between exempt private companies and other companies in respect of either loans to directors or the appointment of auditors (subject to a proviso for existing auditors of exempt private companies which we recommend in Chapter XI below).

59. So far as the filing of accounts is concerned, those who have argued for the maintenance of the existing exemption have relied strongly on the ground that a small family company, particularly one whose operations are local in character, should be entitled to keep its affairs private. It is said that such a business may be in competition with larger undertakings which are under no obligation to disclose the results of local trading and with small unincorporated local businesses, which, of course, are not required to publish accounts. It is also argued that the publication of accounts of small family companies would, in practice, amount to publication of information about the income and assets of the family

running the company. Thus a requirement to file accounts would place the small incorporated business at a disadvantage. It has also been suggested that withdrawal of this exemption would place an intolerable administrative burden on the Registrar of Companies and on the companies themselves. However the Board of Trade have pointed out that annual returns are already required to be filed by all companies and have told us that the Registrar's office would be able to deal with the additional work if, in future, accounts were filed as well. We do not think there is any substance in the argument that a serious administrative burden would be placed upon the exempt companies themselves: they are already required to prepare annual accounts for circulation to members. An additional requirement to annex copies of such accounts to the annual returns which must now be made to the Registrar does not seem to us to be unduly onerous. Moreover, we think that the obligation to file accounts might well tend to secure more regular observance than at present of the obligation to keep them.

60. A practical argument put to us against the exemption is that it deprives traders (and trade protection societies and credit insurers) of the information which they need in order to judge the credit-worthiness of the companies with whom they are trading. For example, representatives of the Trade Indemnity Company told us that "a very large proportion of the risks that we insure are connected with these exempt private companies and it is very difficult to get information which would justify the credit they seek ". The National Association of Trade Protection Societies agreed that their societies could ask the exempt companies concerned for copies of their accounts before judging their credit-worthiness, but added that it would not only be simpler but less embarrassing if they could see the accounts of those companies, as of others, at the Companies Registration Office. Accounts are, of course, usually filed some months after the period to which they relate and may therefore be an unreliable guide to the present position of the company. Nevertheless a series of accounts will give a good indication of the profitability and stability (or otherwise) of a company over a period of years and are, for this reason, useful to those considering its credit-worthiness.

61. We appreciate the argument that the filing of accounts may cause embarrassment or inconvenience to some exempt private

companies though the fears which have been expressed to us on this score are, we believe, exaggerated (like the fears expressed to previous Company Law Committees about the effect of the publication of full accounts by public and, later, by non-exempt private companies). We think that in general such disadvantage as there may be should be accepted because disclosure is right in principle and necessary to protect those who trade with and extend credit to limited companies. But some of the information now required by the Act (or to be required if our recommendations on accounts are accepted) is of much greater interest to shareholders and prospective shareholders than to creditors, and its omission from the copy of the accounts of small unquoted companies, required to be filed with the Registrar and therefore open to public inspection, might perhaps avoid some of the embarrassment without seriously reducing the value to creditors of the filed accounts. Accordingly we would require all companies which

are incorporated with the privilege of limited liability to file their accounts with the Registrar of Companies for the benefit of those who may have dealings with them. But we recommend in paragraph 352 below that directors' emoluments, end company turnover and rents should not be required to be disclosed in the filed accounts of companies whose securities have been neither quoted nor offered to the public (this information should however be given in the accounts of such companies circulated to members and debenture holders).

62. We would, on the other hand, exempt all unlimited companies from the requirement to file accounts: we can see no good reason why they should be treated differently, in this respect, from partnerships and individual traders who trade with unlimited liability.

63. We recommend that:

(a) the distinction between the exempt and non-exempt private company should be ended and the present special privileges of the exempt private company, including the exemption from filing accounts with the Registrar of Companies, should be abolished (see paragraphs 424 and 425 below for proposed transitional provisions relating to auditors of exempt private companies);

(b) unlimited companies should be exempt from the requirement to file accounts.

#### **Distinction between Private and Other Companies**

64. A private company is defined in section 28 as one which by its articles restricts the right to transfer its shares, limits the number of its members to 50 (exclusive of employees and ex-employees and treating joint holders of shares as a single member) and prohibits any offer of its shares or debentures to the public for subscription. The non-exempt

private company has the following material privileges not accorded to public companies:

(a) It is not obliged to file a statement in lieu of prospectus before allotting any of its shares or debentures (Section 48 (3)).

(b) It is exempted from the provisions of section 109 (restrictions on commencement of business).

(c) It is exempted from the provisions of section 130 (statutory meeting and report).

(d) It is exempted from the provisions of section 181 (restrictions on appointment or advertisement of director).

(e) It need have only two members and one director.

65. We have already recommended, in paragraph 31 above that all companies, public and private, should have a minimum of two members and two directors, and if this recommendation is accepted the distinction referred to in (e) will disappear. We have received evidence from many sources to the effect that the requirements in respect of public companies in sections 109, 130 and 181 are obsolete and unnecessary. These requirements are now commonly avoided by the device of incorporating companies in the first instance as private companies and subsequently converting them into public companies. The strongest evidence that these requirements are

obsolete is the apparently universal agreement that their avoidance in this way has harmed no one and we recommend their repeal.

66. The remaining privilege of the private company is its exemption from filing a statement in lieu of prospectus so long as it remains private. In paragraph 252 (j) below we recommend that a statement in lieu of prospectus should no longer be required in any circumstances.

67. We recommend that there should be no distinction in the Companies Act in the treatment of public and private companies and that sections 109, 130 and 181 should be repealed. This would not, of course, prevent the formation in the future of privately owned companies with restrictions on share transfer etc. as has been done in the past.

### **Miscellaneous Matters**

#### *Change from limited to unlimited liability*

68. Section 16 provides that a company registered as unlimited may register as limited. There is however no provision enabling a limited company to register as unlimited. If our recommendation is accepted that all limited companies should, but unlimited companies should not be required to file accounts, it may be that some of the present exempt private companies will wish, in future, to maintain the privacy of their accounts by accepting unlimited liability. We think that provision should be made for this possibility, though we hope it is reasonable to assume that companies will not consider taking this step without expert advice. Section 16 also provides that a company already registered as a limited company may re-register under the Act. The intention of this provision is obscure, it appears to serve no useful purpose and we think that it should be repealed.

#### *Section 19 companies and companies limited by guarantee*

69. The Board of Trade may, as provided in section 19, license a limited company to omit "Limited" from its name. We understand that it is the practice of the Board of Trade to issue licences subject to a condition that no change shall be made to the memorandum or articles of the company without the prior approval of the Board. This condition is imposed in order to ensure that the company continues to comply with the requirements of section 19 for so long as it holds the licence. However, the Board of Trade have drawn our attention to the doubt which exists whether such a company can validly change its memorandum or articles without the prior approval of the Board of Trade, notwithstanding the condition imposed, and simply forfeit its licence in consequence. For example, a section 19 company intending to wind up might (in a case not covered by section 30 (2) of the Charities Act. 1960) delete from its memorandum a clause, which the Board of Trade invariably require, prohibiting the distribution of its assets to the members on a winding up. If the consequence of deleting this clause without Board of Trade approval is only the loss of the licence, the control over such companies would be evaded and we do not think such a situation should be allowed to arise.

70. The Act provides for companies limited by guarantee with or without a share capital. We have been informed that guarantee companies with a share capital are very rarely registered and it has been suggested that

the Act should no longer provide for them to be registered. We agree that if a company is formed with the intention of making *pro rata* distributions of profits to its members it seems inappropriate that it should be able to register as a company limited by guarantee.

*"Incorporated partnerships"*

71. A partnership can be formed to operate during the joint lives of the partners. In the absence of any special arrangement on the death of a partner the survivors who wish to continue (or a sole survivor who wishes to do so) must buy out the deceased's share or the partnership must be wound up. A company, on the other hand, is likely to continue indefinitely and the personal representatives of a deceased shareholder are neither in a position to force the other shareholders to buy his shares nor to insist on a winding up. Yet in fact many companies are intended to be nothing more than partnerships incorporated to obtain limited liability and tax and other advantages.

72. We have been informed that one of the commonest grievances is that of the personal representative left with shares in a private company which is making a surplus sufficient to pay the salaries of the remaining working directors but not a reasonable return on the shares. It has been indicated in evidence that the personal representatives of a deceased share-holder can be prejudiced on these circumstances by their inability to do more than seek relief under section 210 (remedy in case of oppression). It has been suggested that, to meet this point, a new form of corporate body, described as an incorporated partnership, should be statutorily instituted. We think that it would be, undesirable to institute another type of corporate body but that the point should be met, and we think it should be possible to do so, at least to some extent, by the use of suitable special articles (which would require no legislative assistance) coupled with an addition to section 222 making a company liable to be wound up by the Court if any event occurs on the occurrence of which the memorandum or articles provide that the company is to be dissolved.

73. If our suggested new provision were adopted, the desirability of applying it would no doubt require close consideration in each particular case, and the special articles or clauses of the memorandum defining the event on the happening of which it was to operate would need to be carefully framed. For example it could hardly be right to make dissolution ensue automatically on the death of one of two members without first giving the survivor a fair opportunity of buying the deceased's shares at a proper price. It would as a rule also be right to include a provision to the effect that in default of agreement between the parties the price should be fixed by arbitration or (perhaps) determined by the company's auditor. The terms of payment would also require attention. The fair arrangement as to this might well be to provide for payment by instalments over a reasonable period. Given special articles on these lines the event giving rise to dissolution under our proposed addition to section 222 might perhaps be that of default by the survivor in payment of the purchase money or any instalment thereof within a specified (and reasonable) period after it became due. The deceased member's personal representatives would thus be furnished in the

last resort with the right to apply for compulsory winding up as a means of enforcing their rights, while the survivor would only incur that result in the event of his failure to perform his part of the bargain.

74. It will be observed that our proposed addition to section 222 refers to an event provided for in the memorandum or articles in contrast to section 278 (1) (a) which (in relation to voluntary winding up) refers only to an event provided in the articles. Our reason for including a reference to the memorandum is that if the prescribed event were stated in the memorandum, in conjunction with a prohibition of or restriction upon alteration, under section 23 (2) of the Act the maximum possible degree of inalterability would be achieved. For the same reason we propose that section 278 (i) (a) should also be amended to refer to an event provided in the memorandum or articles.

75. We think it should be open to existing companies if they so desire, and subject to appropriate safeguards, to alter their memoranda by inserting a provision dealing with the event on the happening of which the company is to be dissolved coupled with a prohibition against or restriction upon alteration, thus placing themselves in the same position as new companies in this regard. But where again care would be necessary to ensure that the event was so defined as to produce a fair and equitable result as between the members.

### *Partnerships*

76. Section 434 of the Companies Act prohibits partnerships which are formed with a view to carrying on business for gain from having more than twenty members. Section 429 prohibits unincorporated banking partnerships, associations and companies from having more than ten members. The purpose of both prohibitions is to protect the public from the hazards of dealing with large and fluctuating partnerships. The practical impact of section 429 must at present be negligible. We have received no evidence, and we make no recommendation, about it.

77. The restriction imposed by section 434 has brought difficulties for those professional firms who cannot by law, or professional practice or custom, be incorporated and who wish, as many do under existing economic conditions, to have more than twenty partners. The partners in such firms belong to professional organisations which exercise effective control over their members and we do not think it is necessary for the protection of the public to maintain the restriction in their case. We have had no evidence that the restriction causes any difficulty to other partnerships and we think it should be retained for them. We recognise that it may not be easy to define the professions to be relieved but if this proves to be a difficulty we hope it might be met by listing them in a schedule to the Act.

**78. We recommend that:**

**(a) section 16 should be extended to provide that a company registered as limited may register as unlimited with the unanimous consent of all its members;**

**(b) the provision for re-registration of a limited company should be repealed;**

(c) the Act should expressly provide that a company holding a section 19 license should not be able to change its memorandum or articles without Board of Trade approval;

(d) companies limited by guarantee and having a share capital should not be accepted for registration after the coming into force of a new Act:

(e) section 222 stating the grounds on which a company can be wound up compulsorily should have added to it this additional ground;

the event, if any, occurs on the occurrence of which the memorandum or articles provide that the company is to be dissolved;

section 278 (1) (a) should be correspondingly amended to refer to the occurrence of an event described in the memorandum or the articles;

(f) companies incorporated before this additional ground for compulsory winding up has been added to section 222 should be able, subject to appropriate safeguards, to alter their memoranda by inserting a provision dealing with the event on the happening of which the company is to be dissolved:

(g) the restriction on partnerships with more than twenty members in section 434 Should be repealed in respect of professional firms which cannot by law, or professional practice or custom, be incorporated.

## **CHAPTER III**

### **DIRECTORS**

#### **Appointment and Tenure of Office**

79. The provisions of the present Act dealing with the appointment and tenure of office of directors appear to be generally satisfactory, but we have some suggestions to make about sections 185 and 188. Section 185 contains provisions shortly to the effect that (subject to various qualifications) persons over 70 years of age cannot be appointed as directors of public companies (or subsidiaries of public companies) or continue in office after the conclusion of the annual general meeting commencing next after they attain that age except with the approval (expressed by a resolution on special notice) of the members in general meeting, unless the articles of association provide otherwise. We feel that the present provisions are unnecessarily complicated and that simpler provisions, which we recommend in paragraph 85 (a) below, should apply to all companies.

80. Section 187 of the Companies Act provides that an undischarged bankrupt shall not act as a director of, or directly or indirectly take part in the management of, a company without leave of the Court by which he was adjudged bankrupt. Section 188 empowers the Court to disqualify from being a director of, or directly or indirectly taking part in the management of, a company for a period not exceeding five years:

(i) a person who has been convicted on indictment of any offence in connexion with the promotion, formation or management of a company;

(ii) a person "who appears to the Court in the course of winding up a company to have been guilty of an offence under section 332 (carrying on the business of a company for a

fraudulent purpose), or to have been guilty, while an officer of the company, of any fraud in relation to or of any breach of his duty to the company.

We have received criticism that section 188 is at present too narrowly drawn and that the Court should have power similarly to disqualify any person:

(iii) who has 'been convicted of any offence involving fraud or dishonesty whether in connexion with a company or not;

(iv) who has been persistently in default in complying with the provisions of the Companies Act;

(v) who has been shown to have acted recklessly or incompetently in relation to the affairs of any companies of which he is, or has been, a director (or otherwise concerned in the management).

There is nothing in the present Act to prevent such persons from continuing to act as company directors, and we agree that the Court should have power to prevent them from so acting when satisfied that this is in the public

interest. We recognise that it may be difficult to decide in any particular case whether a company director has acted so recklessly or incompetently that he should no longer be allowed to remain a director. But in serious cases where, for example, a man has succeeded in steering a series of companies into insolvency, we think that the Court should be able to put a stop to his activities.

81. As section 188 is now drafted the period of disqualification runs concurrently with any period of imprisonment imposed on the director concerned. This can produce anomalous results and at paragraph 85 (c) we recommend that the period of disqualification should be re-defined.

82. Several witnesses have drawn our attention to the current practice of companies of describing some of their senior officials, who are not members of the boards of their companies, as (for example) "special" or "associate" directors. The object presumably is to confer improved status on the officials concerned, particularly the managers of divisions of large companies, who no doubt carry greater responsibilities than the directors of many smaller companies and who have full discretion, within their fields, to act for their companies. It is objected that the use of such descriptions to denote anyone who is not on the board of directors of a company debases the term "director" and is likely to mislead those with whom he deals. But any move to restrict the use of such descriptions by law would impose a considerable administrative burden in its enforcement and it would create difficulties and embarrassment in companies which have already adopted this practice if any prohibition were extended - as presumably it would have to be - to those at present using these descriptions. It would also be necessary, in our opinion, to make exceptions for such descriptions as "Director of Research". There has been no evidence that the practice has caused harm or damage to anyone and we do not therefore make any recommendation for a change in the law on this matter.

83. It has been suggested to us that provision should be made in a new Act for alternate directors, and also that it should be expressly provided that particulars of these should be registered with the Registrar of Companies and that the information required of directors by the Act should be

required of alternate directors. We do not think that the Act should be burdened with provisions about such matters as the appointment and vacation of office of alternate directors, which can suitably be dealt with in the articles of association if the company so wishes. As regards the provision of information to the Registrar and the other obligations on directors, it appears to us that an alternate director is, in the eyes of the law, in the same position as any other director, though his powers may of course be restricted by the company's articles. He is, we think, now required to provide the information about, for example, his interests, emoluments and shareholdings which other directors are required to give, and we would recommend no change in the law in this respect. When alternate directors are appointed for short periods there are obvious practical difficulties in the way of complying with section 201 but these will disappear if our recommendation in paragraph 456 (p) to repeal section 201 is adopted.

84. The Report of the Patton Committee on Company Law Amendment in Northern Ireland (paragraph 17) says:

"In our view the responsibility of directors for wrongful acts contemplated by the Companies Acts has been the responsibility of natural persons and this has been lost sight of ...

It is important that it should be known who is responsible for the conduct of a company .... A corporation cannot officiate as a director except by delegating its duty to some of its directors or some officer or servant. The person to whom these duties are delegated may change from day to day. Except by examining the minutes there is no means of finding out who at any particular time is exercising the functions of director when a corporation is director of a company."

We agree with the views expressed by the Patton Committee and recommend that corporate bodies and Scottish firms should be prohibited from being directors.

85. We recommend that:

(a) section 185 should be amended to provide that in every company

(i) notwithstanding any provisions to the contrary in the articles of association of a company every director should be required to retire at the annual general meeting following his 70th birthday, but should be eligible for re-election. No person who has attained the age of 70 should, without re-election, continue to hold office as a director after the third annual general meeting following the raveling at which he was last elected;

(ii) the special notice now required by section 185 (5) should no longer be required but, notwithstanding any provisions to the contrary in the articles, the age of every director over

70, proposed for election or re-election, should be disclosed in the notice of any meeting at which it is proposed to elect or re-elect him;

(iii) the above provisions should not prejudice the rights of directors under service agreements existing at the date of publication of this Report. On the other hand, no company should be held liable for damages in respect of a breach of a service agreement, entered into after the date of publication of this Report, by reason merely of its declining to re-elect a director when he has passed the age of 70;

(iv) the effect of the provisions in the proviso in subsection 185 (2) and in subsections 185 (3), 185 (6) and section 186 should be retained:

(b) Section 188 should be extended to cover:

(i) persons convicted on indictment of any offence involving fraud or dishonesty whether in connexion with a company or not:

(ii) persons who have been persistently in default in complying with the provisions of the Companies Act;

(iii) persons who have shown themselves, when acting as directors of companies or when otherwise concerned in their management, to have acted in an improper, reckless or incompetent manner in relation to the companies' affairs;

(c) in cases where the person concerned is sentenced to a term of imprisonment for the offence for which he is also disqualified from acting as a director the Court should have express power to direct that the disqualification should continue for not more than five years after the end of his term of imprisonment;

(d) corporate bodies and Scottish firms should be prohibited from being directors; the prohibition should not have effect until, say, six months after the coming into force of a new Companies Act.

### **Duties of Directors**

#### *General*

86. The Companies Act expressly lays certain duties on directors but is by no means exhaustive in this respect, the larger part of their duties and responsibilities having been determined by extensive and complex case law which does not find expression in the Act. A number of witnesses have therefore suggested that the existing legal duties and responsibilities of directors should be codified in a new Act. Others have suggested that there should be set out as simply as possible, together with such other guidance to appropriate behaviour as might seem useful, in a Directors' Code which would not have the force of law. Our attention has also been drawn to certain Commonwealth Acts which expressly provide that a director shall at all times observe good faith towards his company and act in what he believes to be its best interests.

87. As regards the codification of the existing law we agree with the following opinion, which was expressed to us by the General Council of the Bar and supported by other representatives of the legal profession:

"We think that any attempt to define the duties of directors more clearly would involve the risk that, since it would be impossible to define such duties exhaustively, there would be inevitable lacunae which might well make it more difficult to determine in any particular set of circumstances what these duties were."

This objection would not apply to the inclusion in the Act of a reference to the fiduciary relationship of directors towards their companies such as is contained in some Commonwealth and American Acts provided that it was made clear that any such reference did not over-ride or replace any existing duties under the law. On the contrary we think than a general statement of the basic principles underlying this relationship - nowhere explicitly stated in the present Act - might well be useful to directors and others concerned with company management and we recommend such a provision in paragraph 99 (a) below.

#### *Directors' share dealings*

98. Section 195 requires companies to maintain a register disclosing particulars of all directors' holdings of, and transactions in, securities of their company and of its subsidiaries, holding company and fellow-subsiidiaries. This section was introduced on the recommendation of the Cohen Committee, who reported as follows:

"Whenever directors buy or sell shares of the company of which they are directors, they must normally have more information than the other party

to the transaction and it would be unreasonable to suggest that they were thereby debarred from such transaction; but the position is different when they act not on their general knowledge but on a piece of information known to them and not at the time known to the general body of shareholders ....

... The best safeguard against improper transactions by directors and against unfounded suspicions of such transactions is to ensure that disclosure made of all their transactions in the shares or debentures of companies ...." (Paragraph 86 and 87).

We agree with these observations. We would certainly not suggest that a director should be debarred from buying or selling shares in his company because he as a director must normally have more information than the other party to the transaction. We are, however, concerned to see what can be done (apart from the disclosure advocated by the Cohen Committee and now achieved by section 195) to protect the other party to the purchase or sale by directors of a company's securities where the directors are acting (as the Cohen Committee put it) "on a particular piece of information known to them and not at the time known to the general body of shareholders."

89. We have recommended the inclusion in the Act of a general statement of the director's fiduciary duties to his company. But the case of *Percival v. Wright* [1902] 2 Ch. 421 provides authority for the proposition that no fiduciary duty is owed by a director to individual members of his company, but only to the company itself, and a *fortiori* that none is owed to a person who is not a member. The result is that a director who has by reason of his office acquired in confidence a particular piece of information materially affecting the value of the securities\* of his company (or any company in the same group') will incur no liability to the other party if he buys or sells such securities without disclosing that piece of information. This seems to us to be wrong. We have come to the conclusion that the law should protect a person - whether or not a member of the company or companies concerned - who suffers loss because a director has taken unfair advantage at his expense of a particular piece of confidential information about the company or any other company in the same group in any transaction relating to the securities of such companies.

We realise that it might well be very difficult for the other party to establish that he was transacting with a director; this problem is particularly difficult in the case of transactions through the London Stock Exchange because of the method of settlement. It may also often be difficult for the other party to establish a case. Nevertheless we think a remedy should be provided and we recommend accordingly below.

90. It has been suggested to us, and we agree, that a director of a company should not deal in options in securities of his company or of the group to which the company belongs. A director who speculates in this way with special inside information is clearly acting improperly, and we do not believe that any reputable director would deal in such options in any circumstances. This prohibition should not extend to

*\* In this Report, unless the context otherwise requires, "securities" includes both shares and debentures and "group" means a holding company and all its subsidiaries.*

options to subscribe for securities given to the directors by the company or another member of the group because we consider that the terms of such options are a matter for the company, and that, while restrictions on sales may well be impend by the company, it is not necessary for the law to restrict a director from selling such options in any manner permitted by the terms on which they are given to him.

91. We agree with the suggestions of many witnesses that the provisions for disclosure in section 195 should be strengthened and clarified, and we make recommendations to this effect below.

#### *Compensation/or loss of office*

92. The general rule enacted by sections 191, 192 and 193 of the Act is that any payment to a director of a company "by way of compensation for loss of office or as consideration for or in connection with his retirement from office" is unlawful unless it has been approved after full disclosure. Section 191, which relates to payment by the company, and section 192, which relates to payment (from any source) made in connexion with a transfer of the whole or any part of the company's undertaking or property, require disclosure to the "members" and approval by the "company". Section 193, which relates to payments made in connexion with certain transfers of shares in a company, requires disclosure to and approval by the holders of the shares to which the offer relates. Section 194 (3) excludes from the application of this rule "any *bona fide* payment by way of damages for breach of contract or by way of pension in respect of past services".

93. As we understand sections 191 and 192, disclosure must be made to all members whether they are entitled to vote or not, and the payment must be approved by an ordinary resolution in general meeting. Section 193 (3) (b) requires approval by a meeting of the holders of the shares of the class to which the offer relates. We agree with the suggestions that the approval required under motions 191 and 192 should be by special resolution and the approval required by section 193 should be by a corresponding majority of the members concerned, and that the sections should be extended to cover payments to former

directors of the company. It is arguable that the payments to which the provisions of sections 191, 192 and 193 apply relate only to the office of director in the company concerned. It seems to us that the same considerations apply to payment made to a director in respect of any such office held by him as is mentioned in section 196 (4) and we think that the Act should be amended accordingly. This would have the effect *inter alia* of extending sections 191, 192 and 193 to a payment made to the director of a holding company as compensation for his loss of the office of director of its subsidiary company. Finally, we do not think the members of a company are in a position to judge the appropriateness or otherwise of a proposed payment to the directors unless they are informed of the total payment which it is proposed to make to them. Accordingly we would provide that, where an uncovenanted payment of the kind now requiring disclosure and approval under sections 191, 192 or 193, is to be made. There should also be disclosed any proposed payment of the kind at present exempted from

disclosure by virtue of section 194 (3); we do not propose any alteration of the present rule that the payments to which section 194 (3) applies, being payments to which the directors concerned are legally entitled, do not need the approval of the company or the members concerned.

*Disclosure of directors' other interests*

94. It has been suggested to us, and we agree, that where it is proposed to alter the articles of a company and the alterations in view include provisions improving the position of the directors in respect of remuneration or pensions the law should declare explicitly that those provisions should be adequately explained and separately voted on. We deal with the question of disclosure of directors' interests in notices summoning meetings in paragraph 467 below.

95. Section 199 requires a director to disclose to the board of directors any interest which he may have in contracts which his company enters into with other parties. We have received a large number of suggestions about this section. The matters of fairly widespread concern are that:

(a) section 199 at present requires disclosure of any interest, direct or indirect, however small. According to the standpoint of the witnesses these requirements are criticised as being either virtually unenforceable or excessively burdensome for the directors:

(b) section 199 (2) provides only for notice of an interest in the case of a contract which comes before the board of directors, whereas many contracts are never brought before the board;

(c) section 199 does not in any circumstances require directors' interests to be declared to the members of the company.

In paragraph 99 below our recommendation (1) deals with the first two points. Its effect is to limit the requirement to disclose to *material* interests in contracts, whether or not any such contracts come before the board of directors. We do not think it is unreasonable to expect a director, who has a material interest in a contract, normally to have knowledge of that contract even though it is neither specifically brought to his attention nor brought before the board. But there should be a saving from this provision for cases where a director can show that he in fact had no knowledge of the contract and that it was unreasonable to expect him to have had such knowledge. We think the opportunity should also be taken to extend section 199 (3) so as to enable a director to give general notice of other interests than those arising from his membership of another company or firm, and also to require the nature of the interest to be stated.

96. As regards disclosure of directors' interests to the members of the company, we do not think that it would be desirable or practicable to require any such general disclosure. Our attention has, however, been drawn to the type of arrangement which is sometimes adopted by, for example, investment trust, shipping, tea and rubber companies, whereby agents are appointed to manage the whole or a substantial part of the company's business. In such circumstances, the directors are, in effect, delegating to others part of their duties and responsibilities, and, if they have an interest in the managing agency, are drawing part of their remuneration for the management of the company indirectly through the

agency. We think that where any director has a material interest in such a contract (for example, because he is a director, shareholder or partner in the managing agency) that interest should be disclosed in the directors' report and copies of the contract should be filed with the Registrar of Companies and made available at meetings of the company. Our recommendation does not cover such contracts as those delegating the work of share registration, repair and maintenance of plant, design and technical work, or contracts under which another firm acts as professional advisers (for example, as solicitors, stockbrokers, or financial consultants) even where this is under a long-term retainer. On the other hand, we would include contracts delegating management of any substantial part of the business, notwithstanding that it was considerably less than the whole; for example, if a shipping company had three ships, a management contract in respect of any of them should be included. Similarly, where a company has more than one business, a management contract relating so, or a number of separate management contracts which together relate to a substantial part of any business should be covered notwithstanding that it was not a substantial part of the business as a whole.

97. In order that companies may comply with sections 195 (register of directors' shareholdings etc.), 196 (particulars in accounts of directors' salaries, pensions, etc.), and 197 (particulars in accounts of loans to officers etc.), every director is required by section 198 to give notice of the relevant facts relating to himself. We think the section should require such notice to be in writing and that the requirement should be extended to the information required for the purposes of section 200 (register of directors and secretaries).

#### *Loans to directors*

98. Section 190 makes it unlawful for a company to make a loan to any of the company's directors. We have had conflicting evidence about this provision. It has been suggested that this restriction may make it difficult for some companies to obtain suitable directors and that, in particular, loans in connexion with house purchase to "working" directors should be permitted. On the other hand, it has been suggested that

section 190 can be circumvented and the section would be extended so as to prohibit loans by a company to another company in which the directors of the loading company hold a majority interest. For the same reasons as the Cohen Committee, which we have quoted in paragraph 58, we think it undesirable that companies should lend to their directors and we recommend below that section 190 should be strengthened.

99. We recommend that:

(a) the Act should provide that:

(i) a director of a company should observe the utmost good faith towards the company in any transaction with it or on its behalf and should act honestly in the exercise of his powers and the discharge of the duties of his office;

(ii) a director of a company should not make use of any money or other property of the company or of any information acquired by virtue of his position as a director or officer of the

company to gain directly or indirectly an improper advantage for himself at the expense of the company;

(iii) a director who commits a breach of these provisions should be liable to the company for any profit made by him and for any damage suffered by the company as a result of the breach;

(iv) these provisions should be in addition to and not in derogation of any other enactment or rule of law relating to the duties or liabilities of directors of a company;

(b) a director of a company who, in any transaction relating to the securities of his company or of any other company in the same group, makes improper use of a particular piece of confidential information which might be expected materially to affect the value of those securities, should be liable to compensate a person who suffers from his action in so doing unless that information was known to that person;

(c) a director of a company should be prohibited from dealing in options in the securities of his company or of other companies in the same group. This prohibition should not extend to the acceptance and sale of options to subscribe for securities given to a director by his company or by other companies in the same group;

(d) if recommendation (c) above is not adopted, section 195 (1) should be amended to make clear that it extends to "put" as well as to "call" options;

(e) section 195 (1) should be amended to make it clear that securities in which a director has an interest jointly or in common with others or in which he has a limited interest (such as a life interest) or a reversionary interest or a contingent interest or an interest as the object of a discretionary trust must be disclosed;

(f) a director should be required to notify the company of details of any transaction affecting his holdings within seven days of such a transaction coming to his knowledge, and the details should be entered in the register within three working days of their notification to the company. Transactions to be notified or entered in the register should include those in which sales are offset by purchases (or vice versa) within a Stock Exchange accounting period and consequently are not recorded in any formal instrument of transfer; the maximum penalty for failure to notify and to record such transactions in the register should be a substantial default fine;

(g) the register of directors' holdings should be kept open by the company for inspection by the same persons, on the same terms and during the same periods as the register of members of the company. Copies of the register of directors' holdings should be made available to the public on the same terms as copies of the register of members;

(h) sections 191, 192 and 193 should be extended to cover payments to former directors and it should be made clear that they apply to payments in respect of any such offices as are mentioned in section 196 (4);

(i) the approval required by sections 191 and 192 should be by special resolution of the company and that required by section 193 by a corresponding majority of the members concerned;

(j) in any case in which section 191, 192 or 193 now requires the disclosure of an uncovenanted payment, any payment to the same director at present exempted from disclosure by virtue of section 194 (3) should also be required to be disclosed;

(k) where it is proposed to alter the articles of a company and the proposed alterations include provisions improving the position of the directors in respect of remuneration or pensions, those provisions should be adequately explained in the notice of the relevant meeting or in a document accompanying it and should be separately voted on:

(l) section 199 (2) should be repealed and section 199 (1) should be amended to require a director to disclose any material interest, direct or indirect, in any material contract or proposed contract, including any which do not come before the board, to the board of directors at the first meeting of the board at which it is practicable for him to do so. There should be a saving from this provision for cases where a director can show that he had no knowledge of the contract and that it was unreasonable to expect him to have had such knowledge:

(m) section 199 (3) should be amended:

(i) to permit a director to give general notice of other interests than those arising from his membership of another company or firm;

(ii) to require a statement in any general notice of the nature and extent of the director's interest:

(iii) to provide that the general notice shall be deemed to be a sufficient declaration of interest, for the purposes of section 199, provided that at the time the question of confirming or entering into any contract is first taken into consideration the extent of a director's interest is not greater than that stated in the general notice:

(n) if a company enters into any contract (other than a service contract with a directors whereby any individual, firm or body corporate undertakes the management and administration of the whole or any substantial part of any business of (he company, and a director has a material interest in that contract:

(i) a copy of each such contract together with a return stating the material interest therein of each director should be delivered to the Registrar of Companies within, say, twenty-one days of the making of such contract, or in the case of existing contracts, within a reasonable period after the enactment of a new Companies Act;

(ii) particulars of any change either in the terms of such contract or in the directors' interests therein, should similarly be delivered to the Registrar;

(iii) copies of all such contracts as are in operation and of the returns showing the directors' interests therein should be available for inspection at every general or class meeting of the members of the company;

(iv) a reference to the existence of any such contract should be included in the directors' report for each year during which the contract remains in force;

(o) the notice required by section 198 should be in writing and the duty to disclose should extend to any information required for the purposes of section 200;

(p) section 190 should be extended to prohibit loans by a company to another company in which one or more of the directors of the lending company hold singly or collectively, and whether directly or indirectly, a controlling interest.

#### **Directors' Powers and Shareholders' Control**

100. The articles of association of a company commonly delegate to its directors by Article 80 of Table A or some similar provision all the powers of the company not required by the Act or by its articles of association to be exercised by the company in general meeting.

101. The powers required by the Act to be exercised by the company in general meeting and therefore not capable of delegation to the directors include those of changing the company's memorandum or articles, and in particular its objects (sections 5, 10, 23): of increasing or reducing the company's capital (sections 61, 66); of declaring that the affairs of the company ought to be investigated by an

Inspector appointed lay the Board of Trade (section 165 (a) (ii); of resolving that the company be wound up by the Court (section 2221 or voluntarily (section 278): and of removing a director before the expiration of his period of office (section 184).

102. In theory these powers coupled with the powers of requisitioning meetings and of requiring the circulation of members' resolutions to be proposed at meetings (sections 132 and 140), and the various sources of information available to members, of which we may mention in particular the balance sheet and profit and loss account (section 158), the register of members (section 113 (1)), the minutes of general meetings (section 146), the directors' report (section 157), the auditors' report (section 162 (21)). the register of directors' shareholdings (section 195 (51)). and the register of directors and secretaries (section 200 (6)). would appear to leave with the shareholders a reasonable degree of control.

103. In practice, however, it may be very difficult for a small shareholder in a company of any size, even if he knows his rights under the articles, to rally to his support a simple - let alone a three quarters - majority of the total voting strength, or even the relatively small proportion of it required to support a requisition for a meeting under section 132, or

for the circulation of resolutions under section 140. Moreover, a majority of total voting power and a majority of the voting power exercised at any given meeting are two different things, and, even if the dissatisfied shareholder succeeds in bringing his resolution before a meeting, the smallness of the quorum normally required, and the lack of interest normally shown by the general body of members combine to make it probable that the voting power commanded by the directors at the meeting, albeit a small fraction of the total potential voting power, will suffice to carry the day. Similar considerations apply to any opposition offered to resolutions supported by the directors.

104. But, unless the affairs of the company have gone badly wrong there is seldom any controversy. The directors of reputable companies would much prefer that meetings should be better attended and that more interest should be taken by members in the company's affairs. Members on the other hand are persistently reluctant to concern themselves with the management of their companies, and, so long as satisfactory dividends are paid, are content to leave everything to the directors. This works well enough in the great majority of cases but untoward events, which might have been averted by greater interest on the part of shareholders, do occur.

105. As was observed by the Cohen Committee in paragraph 7 (e) of their report:

"The illusory nature of the control theoretically exercised by shareholders over directors has been accentuated by the dispersion of capital among an increasing number of small shareholders who pay little attention to their investments so long as satisfactory dividends are forthcoming, who lack sufficient time, money and experience to make full use of their rights as occasion arises and who are, in many cases, too numerous and too widely dispersed to be able to organise themselves."

In paragraph 124 they made further reference to the increasing number of small investors, and concluded:

"The growth of investment trust companies and of unit trusts in recent years has tended to divorce the investor still further from the management of his investments. Executive power must inevitably be vested in the directors and is generally used to the advantage of the shareholders. There are, however, exceptional cases in which directors of companies abuse their power and it is, therefore, desirable to devise provisions which will make it difficult for directors to secure the hurried passage of controversial measures, and as far as possible to encourage shareholders carefully to consider any proposals required by law to be put before them by the directors."

106. In consonance with these observations various amendments designed to strengthen the position of shareholders in regard to control were introduced by the legislation of 1947 and 1948, to some of which reference has been made above. Basically, however, the passages just quoted from the Cohen report are as true today as they were in 1945, though we venture to think that the description of "the control theoretically exercised by shareholders" as "illusory" is perhaps now something of an over-statement. The Act provides shareholders with powerful weapons provided they choose to use them, and even if practical considerations make them difficult for the small investor to wield, the same cannot be said of the institutional investor who is not likely to submit to any major abuse of power by the

directors of any company whose members include investors of that description. Moreover where quoted companies are concerned the Stock Exchange requirements and the sanction for them in the shape of refusal or suspension of quotation provide some protection.

107. To say that it is useless to provide investors with further safeguards which apparently they do not want and which, if provided, they will not use is a counsel of despair. Legislation can only proceed on the footing that new powers meeting real needs will, if created, be used.

108. Apart from matters excluded from delegation by the terms of the Act, the extent of the powers delegated to the directors depends on the provisions of the articles by which the delegation is effected, and in theory there is no reason why it should not be restricted in any manner considered expedient by the framers of these articles. In practice, however, the wide form of delegation referred to above is almost invariably adopted, with little of any importance in the way of restrictions beyond those imposed by the Act; though we should perhaps note by way of exception the usual provision limiting the directors' powers of borrowing without the consent of the company in general meeting to a specified amount (which has long been a Stock Exchange requirement where "quoted" companies are concerned, and one form of which is to be found in Article 79 of Table A).

109. Generally speaking, this seems to us to be right. If directors are to manage their company efficiently they must, within broad limits, have a free hand to do what they consider best in the interests of the company.

110. We are satisfied that as a general rule directors do exercise their delegated powers in what they conceive to be the best interests of their companies and pay due regard to the desirability of referring to their shareholders for approval, whenever it is practicable to do so, any proposals of fundamental importance which they have in view, or, failing that, of keeping their shareholders adequately informed about such developments.

111. But it cannot be denied that cases have, albeit rarely, occurred in which directors invested with the usual wide delegated powers have, without committing any breach of the law as it now stands, made use of those powers for the purpose of diverting the company's assets without the knowledge of the shareholders to uses to which the shareholders if they had been consulted might well have objected. It is true that the transaction must be within the objects authorised by the memorandum, so as to be *intra vires* the company and the directors; but cases where the given transaction is outside these objects, and therefore requires a special resolution of the company in general meeting to alter them before it can be carried out, are few and far between.

112. Another power ordinarily included in the general delegation and capable of being exercised by directors to the detriment of existing shareholders without any breach of the law is the power of issuing shares, to the extent of any surplus of authorised but unissued shares which may be available at any given time.

113. After full discussion we have come to the conclusion that a case is made out for legislation (a) designed to ensure that shareholders should be kept more fully informed of the company's activities. (b) excluding from

the general delegation of powers to directors any sale of the whole or substantially the whole of the company's undertaking and assets, and (c) placing the power of issuing shares under a special form of control exercisable by the company in general meeting. Legislation on these lines would, in our view, serve to protect the vital interests of shareholders without hampering directors in their conduct of the day-to-day business of their companies. These three matters are dealt with in greater detail below.

### *Information to shareholders*

114. We have received much criticism about the uninformative nature of many directors' reports. Our attention has indeed been drawn to some from which it is impossible to discover in what business the companies concerned were engaged. Section 157 requires a directors' report to be attached to every balance sheet laid before a company in general meeting. Section 157 (2) provides:

"The said report shall deal, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the directors' opinion be harmful to the business of the company or of any of its subsidiaries, with any change during the financial year in the nature of the company's business, or in the company's subsidiaries, or in the classes of business in which the company has an interest, whether as member of another company or otherwise."

115. Many companies prefer to give detailed information about their operations in the chairman's statement rather than in the directors' report: others take advantage of the proviso italicised in section 157 (2) above. As a result the directors' report has tended to become a formal document stating the appropriations proposed out of profits including the dividend, the directors retiring and seeking re-election, and little else. The practice of circulating the main body of information about the company's activities for the year in the chairman's statement has developed for a number of reasons, and we see no good cause for interfering with it. On the contrary we think that the Companies Act should recognise this development and should allow the information, at present

required to be given in the directors' report, to be provided instead in the chairman's statement or any other document, provided that (i) all the directors of the company are made responsible for the accuracy of the facts stated in this document, (ii) that the statement or other document is circulated with the company's balance sheet and filed with the annual return, and (iii) that a company should not be permitted to put in the chairman's statement (or any document other than the directors' report) any information now required by the Act to be given in the accounts but thereby allowed to be given in the directors' report instead of in the accounts (section 163). We suggest the condition set out at (iii) above because we think it undesirable that information necessary to complete the accounts should be contained in a document on which the auditors are not required to report and we do not think it reasonable to require the auditors to examine the accounts, the directors' report and yet another document before they can make their report.

116. But, in one document or another, a certain minimum of information about its activities should in our view be provided annually by every company and we make recommendations to this end in paragraph 122 below. It is possible that disclosure of such information might on rare

occasions be harmful to the company, though we have not been impressed by the examples of possible damage which have been cited to us by witnesses; and the same objection to disclosure can be, and in the past has been, made against the publication of other information at present required by the Companies Act, in particular of company accounts. We think that the public benefit to be gained from giving shareholders sufficient information to exercise intelligently the powers which the Act bestows upon them should be the over-riding consideration in this matter.

### *Disposal of assets*

117. We agree with the Institute of Chartered Accountants in England and Wales that "in general the principle should be that the function of the directors is to manage the shareholders' business, not to dispose of it." We also agree with the Federation of British Industries who stated that "it is already standard practice among well-conducted companies to obtain the consent of the shareholders to a sale of a substantial part of the company's undertaking." The balance of opinion of witnesses was heavily in favour of some statutory requirement of approval by the shareholders before the disposal of the whole or substantially the whole of the undertaking or assets of the company. Those relatively few who opposed this suggestion did so mainly on the grounds that, by interposing a delay and involving publicity, the Act might in some cases frustrate the directors' attempts to conclude a bargain advantageous to the shareholders. However, if prior consultation were in future always obligatory for all companies we think it unlikely that shareholders would be baulked of an advantageous bargain because of it; the directors would still be able to negotiate and conclude, in privacy, with the purchaser an agreement which was conditional on its subsequent acceptance by the shareholders. In any case it would seem that the possible risk of losing an advantageous bargain must be accepted as a necessary incident of control by shareholders in this fundamental matter.

118. We have also considered the allied question whether the Act should require the prior approval of the shareholders before fundamental changes (within the scope of the company's existing objects clause) are made in the company's activities. We have come to the conclusion that it would be very

difficult, particularly where the nature of the business is gradually changing shape, to define the circumstances in which, and the point of time at which, a fundamental change could be said to be in the making; that it would also be difficult to extend such a provision to the activities of subsidiary and associated companies and that unless the provision were so extended it could easily be evaded by the acquisition of investments in subsidiary and associated companies for this purpose; and finally that our recommendations in paragraph 122 about notification of changes of activities to shareholders and about prior approval for the disposal of the company's and together with the existing and proposed new provisions relating to the authorisation and issue of new capital go far to meet the points which have been put to us on this matter. We do not therefore recommend any new statutory requirements in respect of fundamental changes in a company's activities.

## *Issue of shares*

119. Section 2 (4) provides that the memorandum of association of a company limited by shares shall "state the amount of share capital with which the company proposes to be registered and the division thereof into shares of a fixed amount". It further provides that no subscriber to the memorandum may make less than one share and that each subscriber must indicate in the memorandum the number of shares he takes. Any part of the original capital which is not taken up by the subscribers to the memorandum may be issued in accordance with the terms of the articles of association of the company which will normally leave the matter in the hands of the directors. Under section 61 the company if so authorised by its articles may increase its authorised share capital by passing an ordinary resolution to that effect in general meeting. Once the company has authorised an increase, the articles of association will govern the issue of the new shares with the result that again the matter is usually left to the directors' discretion.

120. Many witnesses have suggested that experience has shown that the directors' unfettered discretion to issue shares (once authorised) has not always worked to the advantage of shareholders. The point has also been made that it is somewhat illogical to require in the Act the consent of the company to an increase in its authorised capital but not to an issue of its capital once authorised. The result is that the directors must, in effect, obtain their shareholders' consent to an issue of shares if they cannot be issued without an increase in the authorised capital, but need not seek consent otherwise. We have been informed of cases where equity shares have been issued for cash below their market value to others than the existing equity shareholders. The effect is to dilute the equity capital, at the expense of the existing shareholders, for the advantage of the newcomers. Some witnesses have defended such issues in special circumstances: where, for example, the issue is made to another company and leads to a profitable association with it. But there is a general consensus of witnesses that issues of equity shares for cash ought always first to be offered *pro rata* to the existing equity shareholders, unless the latter have agreed to some other disposition of them. The London Stock Exchange, in the absence of very exceptional circumstances, requires companies whose shares are quoted on the Exchange to follow this practice. We think it right that issues for cash of

equity shares or securities convertible into equity shares should in the first instance be offered *pro rata* to the existing equity shareholders unless the company has otherwise resolved, and we hope that all stock exchanges in Great Britain will follow the London Stock Exchange, if they do not already do so, in imposing this general requirement. We would not, however, recommend that such a requirement should be imposed by law because we think a certain flexibility, which it would be very difficult to provide in the Act, is necessary in its application. But we do recommend in paragraph 122(h) below the imposition of a statutory control over share issues whether for cash or for other consideration.

121. When issues of shares are made for considerations other than cash the problem is more difficult. If a company can purchase assets advantageously for its own shares instead of for cash the shareholders of the

company concerned will benefit from the transaction and there is obviously no question of a *pro rata* issue to them in such circumstances. Witnesses have told us that, in their opinion, many such transactions would be much more difficult to complete successfully if shareholders' consent to the issue of shares had first to be obtained: the delay and publicity involved would, it is said, in many cases put an end to the transaction. On the other hand, such purchases for shares, if arranged on disadvantageous terms from the point of view of the company, may dilute the shareholders' capital as much as the issue of shares for cash cheaply to outsiders. Moreover, a transaction of this kind, even though completed on terms which are otherwise advantageous to the company, may have the effect of giving control of the company, or a substantial voice in the conduct of its affairs, to persons to whom the majority of members would not wish it to be given. It is not easy to reconcile these conflicting considerations. But we think that the statutory control over share issues for cash or otherwise which we recommend in paragraph 122(h) below would go far to meet the demand for more control by shareholders over share issues without in any way teetering unduly in this respect with the directors' management of the business of the company.

**122. We recommend that:**

**(a) there should be circulated with every balance sheet paid before a company in general meeting a directors' report, chairman's statement or other document containing the following information in addition to that at present required under section 157 (1):**

**(i) the names of the directors;**

**(ii) the main activities of the company and of its subsidiaries during the financial year;**

**(iii) any major changes in these activities during the year;**

(iv) any major changes in the fixed assets of the company and its subsidiaries during the year;

(v) an indication of any substantial difference between the current market value of the company's fixed assets and their book value, where this has not been indicated in the accounts and where the difference is, in the directors' opinion, of real significance to the shareholders (see paragraphs 353-360 below);

(vi) the circumstances in which any capital has been issued during the year;

(vii) whether there is in force any contract (other than a service contract with a director) whereby any individuals, firms or bodies corporate undertake the management and administration of the whole or any substantial part of any business of the company and in which any director has a material interest;

(viii) any other matters, so far as they are material for an appreciation of the state of the company's affairs, disclosure of which would not in the directors' opinion be harmful to the

business of the company or of other companies in the same group;

(b) if the above information is provided in the chairman's Statement or any other document ins/end of the directors' report all the directors should be made responsible for the accuracy of the facts slated in such document;

(c) a company should not be permitted to put only in the chairman's statement (or other document than the directors' report) any matters which are now required to be shown or dealt with in the accounts (or failing them in the directors' report);

(d) prosecutions for failure to observe these provisions should be instituted in England and Wales only with the consent of the Board of Trade;

(e) notwithstanding anything in the memorandum or articles of association the directors of a company should not be able without the specific approval of the company in general meeting to dispose of the whole or substantially the whole of the undertaking or assets of the company;

(f) a third party, dealing in good faith, and for valuable consideration, should not be concerned to see that any necessary approval had been obtained in general meeting for any transaction by which he acquired any assets of a company;

(g) any member should be able to seek an injunction to prevent the directors from concluding, without the requisite approval in general meeting, a transaction of the kind described in (e);

(h) the directors should not have the power to issue any shares in the original or any increased capital of the company without the prior approval of the company in general meeting;

(i) such approval might either be given in respect of any particular issue of shares or take the form of a general mandate authorising the directors, either unconditionally or subject to such conditions or restrictions as the mandate might prescribe, to exercise all the powers of the company in relation to the issue of shares;

(j) each such general mandate should continue in force until the close of the annual general meeting next following its creation and should lapse if not then renewed (with or without modification);

(k) the company should have power by ordinary resolution to revoke or vary any mandate before the annual general meeting at which it is due to expire;

(l) any such mandate might, if the company so thought fit, empower the directors to issue shares, after their current authority had lapsed, pursuant to an offer of shares made by them before it had lapsed; to issue options to acquire shares which might not mature until after the directors' current mandate had lapsed; or to enter into agreements to issue shares in a future year or years after their current mandate had lapsed;

(m) copies of all such resolutions should be required to be forwarded to the Registrar of Companies within fifteen days after the passing thereof and placed by him on the company's file:

(n) the provisions recommended in (h)-(m) above should take effect from the commencement of the company's next annual general meeting after a new Companies Act has been enacted.

## CHAPTER IV

### OWNERSHIP AND CONTROL OF COMPANIES

#### Shares with Restricted or No Voting Rights

123. No exception is taken to the restriction of voting rights so far as preference shares are concerned, but the practice of issuing ordinary or "equity" shares without any right of voting, though not without its supporters, has been strongly criticised, and it is no exaggeration to say that there was a more marked division of opinion amongst our witnesses on this matter than on any other.

124. The opponents of voteless ordinary or "equity" shares (which for the purposes of the present discussion we may call simply "voteless shares ") found themselves on the principle that shares conferring interests in the equity or "risk" capital of a company should carry voting rights commensurate with those interests, and say that given acceptance of this principle it is wrong that the holders of shares representing a minor proportion of the equity, or perhaps preference shares conferring no interest in the equity, should carry voting control, to the exclusion of shares representing a major proportion of the equity.

125. Apart from the general question of principle, the opponents of voteless shares point to specific evils arising or likely to arise from their use. It is said, for instance, that the holders of voteless shares have no redress short of expensive and difficult Court proceedings in the event of misconduct on the part of directors appointed by the voting section of the company's members, however small their interest in the equity may be. It is said further that short of actual misconduct the vesting of the entire voting power in a minority exposes the voteless majority to the risk of the management changing for the worse, and tends to perpetuate inefficient management. The point is also taken that the exclusive voting power of the minority may result in a take-over offer being made for their shares without a reasonable

parallel offer for the voteless shares to which the greater part, if not the whole, of the equity is attached, and this is said to be unfair.

126. More generally the opponents of voteless shares say (in effect) that as a matter of public policy ownership of interests in companies should carry with it some measure of responsibility for their control, and that voteless shares tend on the contrary to establish *de jure* the severance of ownership from control which frequently arises *de facto* from the indifference of shareholders.

127. The practical point is added that the descriptions applied to voteless as distinct from voting shares may not be sufficiently clear to ensure that a purchaser knows which kind he is getting. It is also suggested that even if a purchaser knows he is getting voteless shares he may not fully comprehend the implications.

128. On the other side it is said that the abolition of voteless shares would be an unwarranted interference with freedom of contract. If a company in need of fresh capital chooses to raise it by an issue of voteless shares, and finds subscribers who are ready and willing to take voteless shares for their money, why should the bargain not be carried out in accordance with its terms, suited as it is to the needs of both parties to it?

129. The supporters of voteless shares point to more than one type of case in which voteless shares have served a useful purpose. Suppose the founder and majority shareholder of a family business desires to make provisions for the death duties which will become payable on his shares when he dies, he may well find it convenient to do so by issuing voteless shares, thus raising the requisite funds without losing control. Apart from death duties, voteless shares may be useful where it is desired to raise fresh capital for the extension of a business while leaving control in the same hands as formerly. Again, on an amalgamation between two companies it may well be found convenient to provide for any desired adjustment of control by means of voteless shares.

130. On the same side it is pointed out that if in cases such as those referred to in the last preceding paragraph the issue of voteless share, were to be prohibited, it would be possible, though perhaps inconvenient, to raise the funds required by means of loan capital which would be voteless and the holders of which could (with a little ingenuity) be given rights against profits and assets approximating to those attached to equity shares. A legislative prohibition of voteless shares could also be evaded by giving a right of voting to a given issue of equity shares but nullifying that right by the attachment of loaded voting rights to other capital. The Act, to be effective, would have to deal with these various possibilities of evasion and would consequently be, in the opinion of many, not only exceedingly complicated but also unduly restrictive. It has been suggested that, in the case of quoted shares, the Stock Exchange could enforce compliance with the spirit as well as the letter of any legislative prohibition by refusing a quotation to securities which avoided it; with this assistance, it is suggested, the operation of the Act itself might be simplified. But there are obvious objections to imposing upon the Stock Exchange,

instead of the Courts, the duty of interpreting Parliament's intentions.

131. As to the perpetuation of inefficiency feared by the opponents of voteless shares, the supporters of such shares are able to assert with no less justification that voteless shares may well tend to perpetuate efficiency. Moreover, in the end a company under inefficient management must in a competitive field either become efficient or be submerged.

132. As to the bearing on voteless shares of the principle of public policy above suggested, the supporters of voteless shares might well call in question the existence of any such rule. It is difficult, they might say, to see how any question of public policy is involved in a bargain between an individual wishing to have an interest as a shareholder in a company but having no desire to interfere in its direction, and a management wishing to raise money by the issue of shares but not to part with control, under which the company issues and the individual takes and pays for shares in the company carrying all the normal rights of ordinary shares except

the right of voting. If such a bargain cannot as between the original parties to it be impeached as contrary to public policy, it is difficult - so the supporters of voteless shares might say - to see how it can be so impeached as between the company and any assignee of the shares from the individual who originally took them, or his successors in title.

133. Considerable reliance is placed by the supporters of voteless shares on the difficulty of working out the principle of equating voting rights to interests in the equity propounded by the opponents of voteless shares, and they suggest eases involving several classes of shares in which it would be impracticable to do so.

134. On the same side it is pointed out that the enfranchisement of existing voteless shares in a company would necessarily involve compensation to the holders of the voting shares for their loss of exclusive voting power. The compensation could only come from the holders of the voteless shares, who, it would seem, would thus in many cases be compelled to pay for something they did not want. This follows from evidence to the effect that an investor given the choice between voting and voteless shares in a company may well choose the latter because they are cheaper and because he is not interested in voting rights.

135. The supporters of voteless shares take the view that in the event of discrimination by the voting section of shareholders against the holders of the voteless shares the Court would, under section 210 or otherwise, intervene at the instance of the latter, and we think this view is well-founded.

136. We have found this question a difficult one, but after careful consideration of the arguments either way we have come to the conclusion that the case for abolition by law of voteless shares has not been made out. Notwithstanding the objections to which they may give rise in certain cases we think that their abolition would be too drastic a step. In any case it would be likely to encourage alternative methods of vesting control in the holders of particular shares or classes of shares. So far as we can see this could only be prevented

by imposing a statutory requirement that equity shares should carry voting rights proportional to their rights to participate in the distribution of profits and assets, and that no other shares should have any ordinary voting rights. In our view any such requirement would be unduly restrictive. A minority of the Committee however feel that measures are required to control the growth of voteless shares, and a note by these members is on page 207.

### *Designation*

137. We think there is justifiable criticism of the practice of designating voteless shares simply as "A" or "B" shares without taking further steps to indicate their true character. So far as quoted voteless shares are concerned the Council of the London Stock Exchange issued a press notice on the 19th August, 1957, in which they said they were taking such steps as were open to them to ensure that the public were not being misled when they were being invited to acquire voteless shares. The fact remains that there is a danger that a person may acquire equity shares, whether quoted or unquoted, without realising that they give him either no voting rights or only restricted rights. This seems to us,

however, to be a singularly intractable problem. There are so many ways in which voting rights may be restricted or loaded that it is virtually impossible to draw a line between shares which can be regarded as "voteless" shares for our present purpose and those which may be regarded as carrying full voting rights. In our view, therefore, this is not a matter which could be effectively provided for by legislation providing in advance for all possible types of share and specifying all occasions on which and the manner in which their voteless character should be disclosed. We do, however, feel that a considerable advance could be made by voluntary action on the part of those concerned and we make recommendations below about the form such action might take.

#### *Notice of meetings*

138. There is considerable support for the view that the holders of voteless equity and preference shares should be given a statutory right to receive, for information, notice of all general meetings of the company at the same time as other members, in addition to the annual accounts and directors' reports to which they are already entitled under the Companies Act. They should also be entitled to receive a copy of any chairman's statement which is circulated with the accounts. This would help to ensure that all members were kept informed of developments affecting their company. We have considered, but the majority of us have rejected on grounds of administrative difficulties, the suggestion that holders of voteless shares should be given a statutory right to attend and speak at company meetings. A minority recommendation on this is on page 210.

139. The possibility of giving voteless shares a right of voting on matters of special importance to them or in circumstances such as failure to pay any ordinary dividend for some specified period, has also been raised, but we think the adoption of this suggestion would involve too great an interference with contractual rights and would also unduly favour voteless shares as compared with preference shares with restricted voting rights which enjoy no similar statutory protection.

140. We recommend that:

(a) the Board of Trade should seek to enlist the voluntary co-operation of the Stock Exchange, the press and other institution, and representative organisations concerned, to give full publicity in the press, investment circulars, etc. to any lack or restriction of voting rights attaching to particular equity shares;

(b) notice of all general meetings of their company should be required to be sent to holders of voteless equity and preference shares at the same time as they are circulated to other members (when a meeting is held on short notice the notices should be required to be sent to such shareholders as soon as possible);

(c) holders of voteless equity and preference shares should be entitled to receive a copy of any chairman's statement which is circulated with the accounts.

## **Disclosure of Share Ownership**

141. The Companies Act does not require the register of members to disclose the beneficial ownership of shares in the company. On the contrary, section 117 provides that "no notice of any trust, expressed, implied or constructive, shall be entered on the register, or be receivable by the registrar, in the case of companies registered in England". Section 195, however, requires a director's holdings of his company's shares, whether held in his own name or otherwise, to be recorded in the register of directors' shareholdings. Section 172 gives power to the Board of Trade to investigate the ownership of shares in any company. Under section 172 (1) the Board of Trade may appoint an inspector to investigate ownership if there is good reason to do so. Under section 172 (3), if there is an application by the prescribed number of members the Board must appoint an inspector unless they are satisfied that the application is vexatious. The Cohen Committee recommended, in addition to the Board of Trade's powers now provided by section 172, that every person directly or indirectly the beneficial owner of 1 per cent, or more of the issued capital of a company should be required to make a declaration of the fact to the company who would in return be required to maintain a register of such beneficial ownership. The Government eventually decided, however, that it would not be possible to devise provisions on these lines which were reasonably simple and which could not easily be evaded.

142. In the evidence we have received considerable emphasis has been placed on the administrative advantages of the nominee system which greatly facilitates the efficient conduct of day-to-day business in the City. But many witnesses have expressed the view that the law should require the disclosure of beneficial ownership of substantial holdings of shares if this is practicable, and if it does not interfere with the normal working of the nominee system. Those who take this view believe that the directors, other shareholders, and indeed the employees of a company, all of whom may be materially affected, ought to be able to ascertain the identity of any substantial holder of the company's shares; this is of particular importance in cases where there is reason to suppose that someone may be in the process of buying for control. Even where a holder of a substantial member of shares is not actually buying with this intention it may be of interest to the others concerned to know whether, for example,

someone is in a position to veto a special resolution of the company, and who that person is. We agree, therefore, with the general view that something should be done, if possible, and, despite the undoubted difficulties, we think that something can be done. We are fortified in this belief by the knowledge that in the United States beneficial owners of 10 per cent, or more of shares which are registered on a national Securities Exchange must disclose their identity and report their dealings. In oral evidence to the Committee, Mr. Brownell, one of the witnesses from the United States, commented as follows on this provision in the United States Securities Exchange Act of 1934:

"... we believe it has worked, and that directors and officers and 10 per cent, stockholders have conformed to it to a very remarkable degree. I say that with the greater confidence because in our work we have never encountered any case where the proper reports were not filed, except through

inadvertence. We have had enquiries not infrequently as to how you count up to 10 per cent, and these enquiries often seek interpretations - who are associates, and things of that kind. I have also talked with Mr. Cohen [a Commissioner of the Securities and Exchange Commission] about the extent to which those reports were filed, and he tells me that he believes the officers and directors and 10 per cent. stockholders of all these listed companies are really meticulous in filing them and that during the years he had been with the S.E.C. he thought the number of proceedings instituted for failure to file were less than ten. There is in the 1934 Act a general clause to the effect that wilful violation of that section would carry, a fine of up to \$10,000 and a possible prison term of up to two years; but as far as I know this has never been imposed."

Mr. Cohen in his own testimony corroborated the evidence quoted above and agreed that sooner or later those who failed to report their holdings were generally found out. We think there is great force in this last point. For example, someone who buys shares anonymously with a view to acquiring control of a company would find it difficult to conceal his identity once he had gained control and the possibility that in one way or another over the years his identity might come to light would, if the penalty for non-compliance were substantial, be a powerful deterrent to evasion.

143. Accordingly we would favour a new provision which would adapt section 195 of the Companies Act so as to require the beneficial owner of 10 per cent, or more of the equity capital or of any class of equity shares (or of any other class conferring ordinary voting rights) of a company, whose shares or any class of them are quoted that a recognised stock exchange, to disclose his identity and report his transactions in such shares. The limitation of the requirement to beneficial owners of shares of quoted companies - and mainly equity shares of such companies - would make the number of persons affected by the new provision relatively few, but the companies about which information would be provided would be those companies whose membership is likely to be a matter of interest to investors, potential investors and the public at large. The new provision would not apply to directors of a company, whose holdings of shares in the company and all transactions in them are already required by section 195 to be included in the register of directors' shareholdings. 10 per

cent, owners would be required to notify their holdings, and transactions in the shares concerned, to the company, which would be required to enter them in the register open to the public on the same terms as the register of members.

144. In determining whether he was the beneficial owner of 10 per cent, of any shares of the above description for the purposes of the new provision a person would, following the language of section 195, make account of shares "which are held by, or in trust for him, or of which he has any right to become the holder (whether on payment or not)". We understand that this formula has proved reasonably satisfactory in practice in determining directors' shareholdings and we see no reason why, with certain modifications to which we refer immediately below. It should not also operate satisfactorily to determine the holdings of 10 per cent, shareholders.

145. For the purposes of registration under the new provisions:

(a) where shares are held by one person as nominee for another the nominee should not be under any obligation to comply with.  
or

see to compliance by that other person with the provisions as to registration contained in the new section.

(b) any shares of which a person is, or has a right to become, the holder merely by way of security in respect of any loan, guarantee or other financial transaction made, given or entered into by him in the ordinary course of his business should be deemed to be in the beneficial ownership of the person who, subject to the rights or interests of the person holding the security, is beneficially entitled to the shares in question, to the exclusion of the person holding the security, who should not be under any obligation to comply, or see to compliance by the person deemed to be such beneficial owner, with the aforesaid provisions as to registration;

(c) the remoter of possible interests in shares arising under settlements and so forth could reasonably be ignored, but provision against evasion by means (for instance) of joint holdings would be necessary;

(d) where a person is entitled to exercise or control the exercise of the voting rights attached to any shares and is not otherwise to be regarded as their beneficial owner, that person should be deemed to be their beneficial owner to the exclusion of any other person.

Thus we would propose to exclude from the scope of the new provision, *inter alias*, banks and others who act as nominees and lend on the security of shares deposited with them.

146. We recognise that this requirement could be evaded and we do not pretend that it would not give rise to difficulties of interpretation. We think that a substantial default fine and the attendant fear of discovery would probably reduce cession to negligible proportions, but we would also extend section 172 (appointment of inspectors to investigate ownership of a company) to enable the Board of Trade to investigate cases where default was suspected. We see no reason why the new provisions should give rise to greater difficulties of

interpretation than section 195 itself and we have received no evidence that the latter has proved unworkable in practice.

147. We recommend that:

(a) beneficial owners of 10 per cent, or more of the equity capital of a company, whose shares or any class of them are quoted on a recognised stock exchange, or of 10 per cent. or more of any class of such equity capital, or of any other class of share capital of such company carrying the right to vote at all general meetings of the company, should be required to notify to the company the extent of their holdings of all such shares, (including holdings of any class of such shares which do not amount to 10 per cent. of the total of that class). They should also be required, so long as they remain beneficial owners of 10 per cent. or more of such shares, to notify to the company details of all transactions by them or on their behalf in such shares, within seven days of such transactions coming to their knowledge. Transactions to be notified should include "call" and "put" option dealings and those in

which sales are offset by purchases (or vice versa) within a stock exchange accounting period and which are consequently not re-corded in any formal instrument of transfer;

(b) the beneficial interests to be taken into account for the purposes of the new provision should be those which require registration under section 195 modified on the lines suggested in paragraph 145;

(c) the provision should not require . director who has disclosed holding under section 195 to make any further disclosure in relation to that holding;

(d) the identity of 10 per cent. shareholders, the extent of their individual holdings of, and transactions in, each of the classes of share referred to in (a) above, should be recorded by the company in new register within, say, three working days of notification to it;

(e) the new register should be kept open by the company for inspection by the same persons and on the same terms as the register of members of the company. Copies of the new register should be made available to the public on the same terms as copies of the register of members;

(f) section 172 should be extended to empower the Board of Trade to appoint an inspector to investigate the ownership of the shares of a company when there are circumstances suggesting to the Board that there may have been failure to comply with the above requirements;"

(g) the penalty for failure to notify or to record such transactions in the register should be a substantial default fine.

Subsidiary and Associated Companies

*Definition of subsidiary company*

148. The definition of the relationship between a holding company and its subsidiaries is contained in section 154. Company A is a subsidiary of company B if:

(a) company B

(i) is a member of company A and controls the composition of its board of directors, or

(ii) holds more than half in nominal value of company A's equity share capital; or

(b) company A is a subsidiary of a company which is itself a subsidiary of company B.

The definition is subject to exceptions which are not relevant to the general consideration of the question which follows.

149. The present definition was framed to implement the recommendations of the Cohen Committee who said:

"... the question of control should as a general rule be decisive and we consider that the only case when the absence of legal power to control need not exclude a company from the status of a subsidiary, company should be where the holding company owns more than one-half of the equity, since such

a concentrated holding may well give practical control of the business although the holding company does not necessarily possess a majority of the voting powers." (Paragraph 118.)

In theory, and occasionally in practice, the present definition may result in one company being a subsidiary of two other companies. Moreover, non-voting and restricted voting equity shares have become more common since the Cohen Committee reported and the possibility has accordingly increased that a company might own a majority of the equity shares of another company without controlling the composition of its board of directors. We have therefore considered whether the general rule proposed by the Cohen Committee - that the question of control should be decisive in defining a subsidiary - should be adopted in future without exception, that is, whether (a) (ii) of the definition as stated above should be dropped. For reasons which we hope will be apparent from the paragraphs which follow we have come to the conclusion that this amended definition, based solely on membership and control, should be adopted.

150. The definition of a subsidiary or holding company is important in company law in relation to accounts; to the ownership and acquisition of shares (section 27); to the restriction on a company's giving financial assistance for the acquisition of its shares (section 54); to the disqualifications for appointment as auditor (section 161 (3)); to the power of inspectors appointed by the Board of Trade (section 166); to the prohibition of loans to directors (section 190); to the duty to disclose directors' shareholdings and emoluments (sections 195 and 196). In relation to accounts we think that the new definition, based solely on membership and control, is preferable to the existing one; if company A is not controlled by company B it may be seriously misleading if its accounts are consolidated with those of company B. We recognise that one result of this change will be that a company may have 90 per cent. or more of the equity share capital of another without that other being its subsidiary. In such a case there will be no obligation to consolidate the accounts of the two companies - and indeed the presentation of consolidated accounts would not meet the requirements of the Act - and investors in the company which holds the shares will be entitled to less information than they are entitled to under the present law. As against this, it should be borne in mind that if our proposals at paragraph 369 are accepted,

investors in a company will be entitled to more information about its holdings in associated companies than they are entitled to under the existing law. For the purposes of sections 161, 166, 190, 195 and 196 the new definition seems to us to be at least as satisfactory as the existing definition. In paragraph 187 we propose new provisions in replacement of section 54, and we think that the adoption of the new definition of a subsidiary would be satisfactory in relation to these new provisions. Lastly there remains section 27, which is considered below.

#### *Section 27*

151. Section 27 (1) provides that, with minor exceptions, a subsidiary may not be a member of, and therefore may not acquire shares in, its holding company. Section 27 (3) provides an exception for a subsidiary which was at the commencement of the 1948 Act a member of its holding

company, but in such a case the subsidiary is precluded from exercising its voting rights. These provisions appear to serve a two-fold purpose. First, the section prevents the directors of a holding company from maintaining themselves indefinitely in office, against the wishes of other shareholders, with the votes of shares held by a subsidiary. Secondly, section 27 operates to prevent the capital of a holding company from being indirectly depleted as the result of the purchase of its shares by its subsidiary.

152. We have received a number of criticisms that the Act does not go far enough in dealing with the first mischief, that is perpetuation of directors' control. Our attention has been drawn to the case where, for example, three companies (with a common board of directors or with boards which agree to act in concert) each have a holding of 26 per cent. of the ordinary voting shares of each of the other companies. In these circumstances the board of directors of each company, with the assistance of the boards of the other companies, command a majority and therefore cannot be removed by the remaining shareholders. A similar situation arises in practice where two or more companies have substantial cross-holdings in each other even though these provide something less than a majority. Then there is so-called "circular ownership": company A holds 40 per cent. of the ordinary voting shares of company B which holds 40 per cent. of the ordinary voting shares of company C, which in turn holds 40 per cent. of the ordinary voting shares of company A. The directors of all three companies, if they act in concert, can in practice prevent the removal of any of them by the other shareholders. We agree with the view that arrangements of this kind run counter to the general intention of section 184 of the Act, which provides that a director may be removed at any time by ordinary resolution of the company, since directors holding no shares at all in the companies which they direct can by these means maintain themselves indefinitely in office.

153. We have given careful consideration to the possibility of extending section 27 to prevent such arrangements being made. We have considered, for example, whether section 27 might be extended so as to provide that, if company B controlled, say, 20 per cent. or more of the ordinary voting rights of company A, then company A should be prohibited from exercising its voting rights in respect of any shares which it might hold in company B. There are, in our opinion, a number of objections

to provisions on these lines. First, we think that many cross-holdings of this nature are advantageous for all the shareholders concerned and that it would not be right to prohibit them all. Secondly, there would be considerable difficulties of definition: if company A and company B simultaneously obtain holdings of 20 per cent. in each other, which company should lose its voting rights? (The same problem would arise if the provision were to apply to cross-holdings in existence when the now Act entered into force.) If company B controls 20 per cent. of the ordinary voting rights of company A and company A thereafter obtains 90 per cent. of the ordinary voting shares of company B, is it reasonable to provide that company B should continue to exercise its voting rights in company A but not *vice versa*? With these considerations in mind we have somewhat reluctantly come to the conclusion that the complexity and arbitrary nature of the necessary provisions would not be justified by the mischief which they would be

intended to prevent. Moreover, if our recommendations at paragraph 147 for making compulsory the disclosure of a ten per cent. holding of the equity share capital of quoted companies are adopted the existence of substantial cross (and circular) holdings will become public knowledge and subject to press comment so that investors and prospective investors may be warned. Finally, if cross holdings are used by the directors of associated companies to pursue policies which are oppressive, the outside shareholders have a remedy in section 210.

154. Our attention has also been drawn to the fact that shares in a company may in certain circumstances lawfully be held in trust for it, and that its directors would in such a case be able to use the votes concerned by such shares towards maintaining themselves in control against the wishes of the remaining shareholders. To avoid this undesirable result, any shares of a company which are held in trust for it should, in our opinion, carry no right to vote so long as they are so held.

155. We have received no evidence that the safeguard against the depletion of a holding company's capital provided by section 27 is inadequate. We suggest, therefore, that in the ordinary way a subsidiary should continue to be precluded from being a member of its own holding company. There are, however, a number of respects in which it has been urged that this rule should be relaxed (in addition to the exemption now provided by section 27 (3)). First it has been suggested, and we agree, that a subsidiary, which was a member of its holding company before it became a subsidiary, should be permitted to continue to be a member but not to exercise its voting rights. Secondly, we agree with the suggestion that a holding company should be permitted to allot fully paid shares, by way of capitalisation of reserves, to a subsidiary which is a member of the holding company. We would not, however, relax the prohibition on a subsidiary's subscribing for shares in its holding company where such shares are offered on advantageous terms to the shareholders of the latter, but we would make it plain that the holding company is free to sell the rights on behalf of the subsidiary. Finally, we have been told that section 27 causes difficulty to mutual insurance companies whose subsidiaries wish to re-insure with them, where the constitution of these companies provides that only a member can be a policy holder. We have not examined in detail the

reasons why companies of this class cannot alter their constitutions to meet the difficulty but if there is any substantial objection to their doing so we think an exception from the provisions of section 27 might be made in their favour.

156. We recommend that:

(a) section 154 (which defines the relationship between t holding and subsidiary company) should be amended by repeal of section 154. (1)(a)(ii) so that the definition of a subsidiary is in future based solely on membership and control;

(b) It should be provided that any shares of a company which are held in trust for that company should carry no right to vote so long as they are so held;

(c) section 27 should continue in force, subject to the following extensions and exemptions:

(i) a subsidiary, which was t member of its holding company before it became a subsidiary, should be permitted to continue to be a member but should have no right to vote in respect of any shares it may hold in the holding company;

(ii) a holding company should be permitted to allot fully paid shares, by way of capitalisation or reserves, to a subsidiary which is a member of the holding company;

(iii) it should be made clear that a holding company is free to sell, on behalf of a subsidiary, say shares which, but for section 27, would have been offered to that subsidiary by virtue of shares already held by the subsidiary in its holding company;

(iv) an exemption should be made in section 27 in favour of mutual insurance companies, if there is any substantial objection to such companies' altering their constitutions so as to permit their subsidiaries, not being members, to re-insure with them.

## CHAPTER V

### REDUCTION OF CAPITAL AND THE PURCHASE BY A COMPANY OF ITS OWN SHARES

#### *Reduction of Capital*

157. The Companies Act does not expressly prohibit the reduction of capital but it has been held that the terms in which section 66 permits a reduction of capital impliedly prohibit a limited company from reducing its share capital except as expressly permitted by the Act. We think it would make for clarity if the Act provided that, save as expressly pertained, a limited company must not reduce its "capital", by which we mean (to use the nomenclature appropriate to par shares) the aggregate of the issued share capital of the company and the share premium account and capital redemption reserve fund (if any)

158. It has been suggested that in some circumstances, for example, where the reduction consists simply of cancelling paid up share capital which is lost or is represented only by such intangible assets as goodwill, it should not be necessary to obtain the consent of the Court. We think this relaxation of the presto rule could be accepted only if it were accompanied by provisions designed to ensure that the reduction was not used as a device for indirectly making capital available for the payment of dividends; this would add to the complexity of the law and for that reason, and because we do not think the need for obtaining the consent of the Court imposes any real hardship, we do not agree with this suggestion.

159. We understand that it is many years since the Court has exercised the powers conferred by section 68 (2) to direct a company which has reduced its capital to add the words "and reduced" to its name and to publish information with regard to the reduction. We see no further need for this provision and think that it and section 68 (3) might well be repealed.

160. The procedure for the reduction of capital is designed to protect both creditors and shareholders. We have received no evidence that the interests of creditors are not effectively safeguarded; it has been suggested, however, that it is not always possible for the Court to protect the interests of a section of shareholders unfairly prejudiced by a reduction of capital and that provision might be made whereby the court could obtain an independent assessment of the justice of a reduction scheme. The scrutiny of such schemes made by the Registrar of the Companies Court in England and by the independent reporter in Scotland go far to meet tiffs suggestion and we do not think that any further provision is necessary. If a minority of shareholders think they are being unfairly treated, they can oppose the petition, and if the Court thinks that further expert evidence on the effect

of the scheme would be desirable, it already has the power to refuse to sanction the reduction unless such evidence is produced.

### *Share premium*

161. Section 56 provides that "where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares" must be transferred to a share premium account, and applies to this account the provisions of the Act relating to reduction of share capital as if the account were paid up share capital so that (subject to some specific exceptions which we mention below) the account may not be reduced save with the leave of the court. Distributions by way of dividend from the account without such leave are thus made illegal as being in effect a reduction of share capital. Section 56 was based on a recommendation in paragraph 108 of the Cohen committee Report, which was probably only directed to share premiums in the ordinary sense of premiums received in cash. The section in fact extends the conception of share premium to a transaction for a consideration other than cash so as to require the value received by a company in excess of the amount credited as paid up on shares issued in exchange to be treated as share premium; but there is a division of opinion whether the section (a) applies only where either on the face of the transaction a premium is expressly provided or a premium is reflected in the entries in the books relating to the transaction or (b) also extends to every transaction where there is such an excess value.

162. We have considered whether section 56 serves a useful purpose. We have had no demand for its repeal and the principle that share premium is to be treated as if it were share capital has been widely supported. In the circumstances we do not think the section should be repealed. We have also given consideration to the difference of opinion described above. We see no reason why the section should distinguish between the excess value received by a company on a cash issue and the excess value received on a transaction for a consideration other than cash, except that the amount of the excess on a cash issue is precisely ascertainable, whereas in cases where the consideration is other than cash the excess is a matter of opinion. We have come to the conclusion that,

whatever may be the right construction of the law as it now stands on this matter and without prejudice to what may have been done in the past, section 56 should provide in future that a share premium arises whenever a company receives value in consideration for and in excess of the amount credited as paid up on shares issued in exchange however the transaction is carried out, and however it is treated in the books of the company.

163. Section 56 permits the share premium account to be applied, without the leave of the Court, to writing off the preliminary expenses of the company and the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures and in providing for the premium payable on redemption of any redeemable preference shares or of any debentures. The account may also be applied in paying up unissued shares to be issued to members as fully paid shares. We think the section should be amended to prohibit the application of the account in writing off the expenses and commission paid and discounts allowed on any issue

of debentures or in providing for any premiums payable on the redemption of debentures, since these are part of the ordinary expenses of borrowing. Further there is doubt whether "the expenses of any issue of shares ..." (section 56 (2) (b)) include the capital duty paid on the creation of those shares and we think the section should be amended to make it clear that they do, no matter when that capital duly is paid.

164. We recommend at paragraph 346 that the rules for establishing the share premium account should be modified where an acquiring company intends to treat part of the pre-acquisition profits of a subsidiary as a reserve available for distribution to its own members.

165. We have considered a proposal that the share premium account should be applicable in writing down (a) goodwill in a company's balance sheet and (b) an item in the nature of a balancing item (sometimes referred to as goodwill), arising on the acquisition of a subsidiary, in the consolidated accounts of a group of companies. We reject this proposal since it might indirectly permit the distribution of the share premium account by way of dividend if there was a surplus in case (a) on the subsequent realisation of the goodwill or in case (b) on the subsequent realisation of the shares in subsidiaries which had been written down so as to reflect the reduction of the company's share premium account necessary to eliminate the balancing item from the consolidated accounts.

166. The expenses which we contemplate should be chargeable to the share premium account extend beyond the expenses which the Gedge Committee recommended should be chargeable to the stated capital account in the case of a company having shares of no par value (see recommendation 7 in paragraph 72 of their Report). We would extend their recommendation so that the expenses to be deductible in the case of the stated capital account would be the same as those which we recommend should be deductible from the share premium account.

*Purchase by a company of its own shares*

167. The case of *Trevor v. Whirworth* (1887) 12 App. Cas. 409 established that it is unlawful for a limited company to purchase its own shares, such a purchase being regarded as a reduction of its share capital. There is now a statutory exception to this rule in the form of section 58 of the Act, which permits a company to redeem preference shares but imposes safeguards which are designed to ensure that the amount of the issued share capital is preserved intact. In the United States there is no general rule prohibiting limited companies from buying Shelf own shares and we have considered whether this general rule should be retained in our law. In the opinion of our American witnesses the power enjoyed by companies in the United States has not led to abuse and it is useful for a number of purposes. An American company wishing to provide its employees with shares as part of a bonus plan or a profit sharing scheme, or to acquire other companies, will often accumulate a sufficient number of its own shares by purchase in preference to issuing new shares and thereby unnecessarily increasing its issued share capital. As companies in the United States are generally free to reduce their share capital without the consent of the Court, this power for a company to buy its own shares also makes it possible to effect a selective reduction of capital, the shares

of those members who wish to sell them being bought by the company and then cancelled: members of small companies wishing to retire are often bought out in this way. If a company buys its own shares and does not cancel them, those shares may be re-issued, but in the meantime no votes may be cast and no dividends may be paid in respect of them. Our witnesses pointed out, however, that the case law of the United States imposes very strict liabilities on directors and they considered that this would deal adequately with any abuse of the power by a company or its directors.

168. In our view, if the Companies Act were amended to give a limited company a general power to buy its own shares it would be necessary to introduce stringent safeguards to protect both creditors and shareholders. We think it would be possible to devise effective safeguards and we do not think they need to be unduly complicated. On the other hand, we have received no evidence that British companies need this power and the relatively few witnesses who offered any evidence on this matter were almost unanimous in opposing the introduction of a general power for companies to buy their own shares. The power might occasionally be useful when a minority of the members of a small company whose shares were not readily marketable wished to retire from the company and the other members were unable or unwilling to buy their shares at a fair price; we doubt if such a power would often be exercised for this purpose since it would usually give rise to a surtax assessment in respect of past profits of the company still undistributed and, in cases where tax difficulties can be overcome, a quasi-purchase of the shares of the company can be, and in practice is, carried out by the machinery of a reduction of capital by repaying those shares at a premium. We have therefore reached the conclusion that there is no justification for the general abrogation of the familiar rule that a limited company may not buy its own shares; indeed, we think that the rule should be expressly stated in the Act.

169. We have considered whether a special exception should be provided for companies which operate profit-sharing schemes involving the issue of shares to their employees. The value of such shares will to a great extent depend upon their being freely marketable. The employee, if the shares are not quoted or if his holding is small, may find it difficult to sell them. In such circumstances, it is argued, the company should be empowered to provide a market in the shares. We received no

evidence that this problem presented insuperable difficulties and on the evidence presented to us we do not think that the proposed exception would be justified. For the same reason, we do not accept the suggestion that section 27, which prohibits a subsidiary from acquiring shares in its holding company, should be modified in favour of profit-sharing companies.

#### *Section 54*

170. Section 54 of the Act makes it unlawful for a company to give financial assistance for the acquisition, by purchase or subscription, of its own shares or those of its holding company. There are exceptions for loans in the ordinary course of a company's business and for the provision money for the acquisition of shares for the benefit of employees. Contravention of this section is an offence rendering the company and every officer who is in default liable to a fine of £100.

171. Many witnesses complained that the section is drawn in terms so wide and general that it appears to penalise a number of innocent transactions; some indeed questioned whether the section served any intelligible purpose and suggested that it might be repealed. Others, on the other hand, felt that the section should be retained and strengthened but agreed that it should be clarified. There seems to be general agreement that it is widely disregarded.

172. The section re-enacts, with amendments, section 45 of the Companies Act, 1929, which was introduced on the recommendation of the Greene Committee. That Committee gave an example in their Report of the sort of transaction against which their recommendation was aimed: - A "syndicate" acquired control of a company by buying shares out of borrowed money, which they proceeded, when they had appointed themselves to the company's board, to repay from money lent to them by the company. The company thus provided money for the purchase of its own shares. The Greene Committee thought that such an arrangement offended against the spirit, if not the letter of the law, which prohibited a company from trafficking in its own shares. They added that the practice was "open to the gravest abuse."

173. We do not think that the practice whereby a company provides financial assistance for the acquisition of its own shares necessarily offends against the rule that a limited company may not buy its own shares, and, had section 54 been designed merely to extend that rule, we should have felt some doubt whether it was worth retaining. The reason why a limited company may not buy its own shares is that in doing so it would part outright with the consideration for the purchase and thereby reduce its capital. A company which lends money to a person to buy its shares simply changes the form of its assets and if the borrower is able to repay the loan the company's capital remains intact. If in the circumstances, the assurance given to the purchaser is improper and the company suffers loss, the directors who are parties to the transaction will be liable for misfeasance. In our view, however, the purpose of the section is to prevent the abuses which are likely to, and indeed do, arise when the practice is followed. If people who cannot provide the funds necessary to acquire control of a company from their own resources, or by borrowing on their own credit, gain control of a company with large assets on the understanding that they will use the funds of

the company to pay for their shares it seems to us all too likely that in many cases the company will be made to part with its funds either on inadequate security or for an illusory consideration. If the speculation succeeds, the company and therefore its creditors and minority shareholders may suffer no loss, although their interests will have been subjected to an illegitimate risk; if it fails, it may be little consolation for creditors and minority shareholders to know that the directors are liable for misfeasance. In recent times there have been some flagrant abuses of this kind to the serious detriment, particularly, of minority shareholders. We therefore think that section 54 would be retained and strengthened.

174. We were informed that there is much difference of opinion about the scope of the section and some of our witnesses feared that it prohibited a number of quite innocent transactions. We do not think that all the

transactions described in the following paragraph are necessarily prohibited by the section as it is now drafted, but they have all been represented to us as transactions which may be prohibited by the section even when they are quite unobjectionable.

175. (a) *company A makes an offer to acquire control off company B in exchange for its own shares: as an added incentive to the shareholders of company B, company A arranges that company C will buy from them any of their newly acquired shares in company A at an agreed price; company A pays company C a reasonable commission for this service;*

*(b) company A allots its shares in order that they may be offered to the public; it pays the expenses of the offer.*

These payments seem to us to be outside the purpose of section 54 and, so far as they are not already so regulated, should be regulated under the provisions relating to the payment of commission in connexion with the issue of shares; they should not fall within the ambit of section 54.

*(c) A borrows the money to buy control of company B and then causes company B to pay a dividend, which company B can properly do, and uses the dividend to repay the loan;*

We see no objection to this transaction. The payment of a dividend properly declared is no more than the discharge of a liability and we cannot see why the discharge by a company of a lawful liability should be regarded as giving financial assistance to the creditor. Such a payment cannot prejudice the rights of the creditors, while minority shareholders will directly benefit from it.

*(d) A acquires control over company B; he borrows money to pay for the shares. The original arrangements for repayment of the borrowed money did not contemplate using the funds of company*

*B; those arrangements for some reason fall through and A borrows the necessary money from company B;*

*(e) company A acquires control of company B and decrees that the liquid assets of company B can be put to better use by company A; company B therefore lends its liquid assets to company A;*

We can imagine circumstances in which these transactions would be entirely proper; we can equally imagine circumstances in which they would be objectionable and in the following paragraphs we consider how to differentiate between those transactions which are objectionable and those which are not.

176. We think it important to recognise that real practices occur only in a small minority of cases and to try to ensure that provisions designed to prevent them should not prove an embarrassment to the great majority of honestly conducted amalgamations and take-overs. From the evidence we have received, we are satisfied that section 54, as it is now framed, has proved to be an occasional embarrassment to the honest without being a serious inconvenience to the unscrupulous. The problem, as we see it,

is how to strike more effectively at the latter while causing less embarrassment to the former. The cases in which the really scandalous malpractices have occurred have this feature in common, that an acquirer finds himself in control of a company with large liquid assets when he is under an obligation to pay for that control and has no prospect of paying for it except out of the company's funds. The probable result is only too familiar: in one way or another the acquirer will use the company's funds to discharge his obligations and, when the facts are ultimately discovered, the company's remedies against him will be worthless, either because he has disappeared, has disposed of his assets, or is insolvent, and minority shareholders and creditors will suffer accordingly. The ideal solution would be to prevent this situation from arising instead of, as now, merely penalising the objectionable transactions after they have taken place. It is obvious that a person, who seeks without adequate funds of his own to obtain control of a company, can succeed only with the initial assistance of third parties. It appears to be a common practice for the intending acquirer to borrow the purchase price of the shares necessary to give him control from a bank or other similar institution. We can see no harm in this if it does not result in the acquirer's obtaining control in circumstances in which he cannot repay the initial loan except by using the funds of the company for the purpose; but, when this result is likely to follow, we regard the initial loan as being the first and indispensable step in a series of transactions which may lead to fraud. The problem that has exercised us is how to identify the initial step that must, if possible, be prevented without thereby throwing an unfair burden of responsibility upon banks and other institutions. Some arrangements should plainly be penalised; cases have been drawn to our attention in which it must have been perfectly clear to those lending money or giving credit to a person who intended to buy control of a company that the company in question had large liquid assets and that there was no prospect of the acquirer's being able to discharge his obligations except from the funds of the company; in some cases, indeed, it seems to have been an essential term of the arrangement between the acquirer and the original lender that the funds of the company should be made available for the purpose of enabling the acquirer to discharge his debt to the lender.

177. We have considered the possibility of making it an offence for any person to advance money to another for the purpose of enabling that other to acquire control of a company

where the lender knows or ought to know that the borrower has no reasonable prospect of repaying the loan except out of assets of the company. We have come to the conclusion that such a provision would be unnecessarily wide. The danger involved in permitting a company to give financial assistance for the acquisition of its own shares is that minority shareholders and creditors may be prejudiced. Where there are no minority shareholders and no creditors there is no such danger. Furthermore, we do not think it would be possible to make such a provision effective except at the cost of imposing an unreasonable burden on banks and other institutions from whom the advances necessary to acquire control are habitually obtained; the effect would be that a lender could never be certain without making detailed enquiries whether he was committing an offence or not.

178. Indeed, having identified the mischief which we think it necessary to prevent, we see no need even for the general prohibition now contained in section 54 and would substitute a new provision declaring it to be unlawful for a company to give financial assistance (as described in section 54 (1)) for the acquisition (whether by purchase or subscription) of its own shares or shares of its holding company unless the following conditions have been fulfilled before such assistance is given:

(a) that the transaction whereby the assistance is given has been approved by a special resolution of the company;

(b) that a statutory declaration of solvency on the lines described below and made by the directors of the company has been filed with the Registrar of Companies.

The first of these conditions should in itself afford a considerable measure of protection to minority shareholders. They will be given notice of what is proposed and will thus have an opportunity of taking action to protect their interests; if in fact they control more than 25 per cent. of the voting rights, they will be able to veto any transaction which they think objectionable. In addition, we think that a dissentient minority holding 10 per cent. or more of the shares of the company or any class of them should be given a right, similar to that conferred by section 72. to apply to the Court to prohibit the proposed transaction. This right should be without prejudice to any rights individual shareholders may enjoy at common law or under section 210. The Act should provide that the proposed transaction is not to be effected until either (a) the time prescribed for any such application (say 28 days after the passing of the special resolution) has expired without any application being made. or (b) the special resolution was passed with the approval of all members, or (c) the Court has approved the transaction.

179. The second condition is designed to protect creditors. It scans to us that, in practice, it is minority shareholders rather than creditors who are liable to be prejudiced by the transactions now in question, but we cannot ignore the

possibility that creditors may be prejudiced. We think the statutory declaration should state:

(a) the form the assistance will take the persons to whom it is to be given and the purpose for which it is intended they shall use it;

(b) that the declarants have made a full enquiry into the affairs of the company and that, having done so, they have formed the opinion that the company, having effected the transaction where by such assistance is to be given, will be able to pay its debts as they fall due.

We do not think it reasonable to require the declarants to make their declaration on the footing that the funds used or committed by the company in giving the assistance in question will necessarily be lost to the company, but we do think it essential to require the effect of giving the assistance to be taken into account in making the declaration. The declaration should be required to be made at a meeting of the directors, by all the directors, or in the case of a company having more than two directors, by a majority of the directors. There should be a substantial

penalty on any director who makes such a declaration without reasonable grounds and there should be a presumption that a declaration has been made without reasonable grounds if within 12 months of the filing of the declaration the company goes into Liquidation and its debts are not paid in full within 12 months of the commencement of the winding up.

180. The words at present used in section 54 to describe the kind of financial assistance which we are now considering ("whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise...") have been criticised on the ground that the words "or otherwise" are difficult to interpret in this context and give rise to doubt and uncertainty. We do not think it wise to attempt any more precise formula for describing the sort of transaction which may be the means of giving financial assistance, but we think it should be made clear that the discharge of a lawful liability or the payment of a dividend lawfully declared is not to be regarded as the giving of financial assistance. On the other hand it should be made clear that financial assistance is deemed to be given by a company if, within a period of, say, 12 months of the acquisition of a controlling interest in it, the company purchases any asset from the controlling shareholders or from any company directly or indirectly controlled by them.

181. If a company acts in breach of the conditions proposed in paragraphs 178 and 179 a substantial penalty should be imposed on any officer who is in default; we do not think it would be reasonable to impose the penalty on the company, as section 54 now does, since this not only penalises the minority shareholders the section is designed to protect but may involve the company in difficulties if it wishes to take civil proceedings for misfeasance or conspiracy. On the other hand, it should be made clear that a transaction in breach of the suggested conditions will be voidable at the instance of the company as against any person (whether a party to the original transaction or not) who has notice of the facts. If the assistance makes the form of a loan, this will make little or no practical difference; if, however, it takes the form of the giving of security or a guarantee the effect will be to reverse the decision of the Court in the case of *Victor Battery Co. Ltd. v. Curry's Ltd.* [1946] Ch. 242.

182. It may be objected that the suggested provision will leave unaffected the position of the lender whose initial advance makes possible the transactions we wish to prevent. After careful consideration we have come to the conclusion that such an objection would be ill founded. There seems to be no reason why a lender who knows neither the purpose of the loan nor the fact that repayment to him has been made possible by a breach of the provision proposed above should be prejudiced in any way. If the lender has notice of the purpose of the loan and accepts repayment without enquiring whether the suggested provision has been complied with or accepts repayment knowing that repayment has been made possible by a breach of that provision, we think he should be liable to compensate the company to the extent that it has been prejudiced. We do not, however, think that any express statutory provisions are necessary to produce this result. A transaction whereby a company assisted the purchase

of its own shares in breach of the suggested conditions and to its prejudice would be a misfeasance on the part of the company's directors and in such a case the company (or its liquidator) would have a remedy against the directors. There would also be a remedy both against the person to whom the assistance was wrongfully given and against the original lender who had been repaid by means of assistance thus given, if they acted with knowledge of the facts. We do not think that our proposals should prejudice these remedies in any way. On the other hand we would expect that a lender, knowing that the conditions we have suggested above must be complied with before the borrower will be able to repay his loan, will be more careful in making advances and, in most cases, will satisfy himself before he makes his loan that those conditions will be capable of being fulfilled.

183. Where it is proposed that a company shall give financial assistance for the purchase of shares in its holding company the safeguards we have suggested above should be imposed in relation to both companies.

184. In addition to the general criticism, which we have considered above, of the prohibitions imposed by section 54, we have received some derailed criticisms of the exemptions in favour of employees contained in subparagraphs (b) and (c) of the proviso to subsection (1). It has been pointed out that both the exceptions set out in subparagraphs (b) and (c) are too narrow in that they apply only for the benefit of the employees of the company or its holding company. We think a holding company should be free to enter into arrangements for the purchase of its shares or those of its own holding company for the benefit of the employees of its subsidiary.

185. Subparagraph (c) of the proviso to section 54 (1), which permits a company to make loans to its employees to enable them to acquire its shares, does not permit loans to a company's directors. Despite representations that it might be modified in favour of "working" directors we think the restriction should continue and that there should be no exception to the prohibition on loans to directors.

186. It has been suggested that the provisions of subparagraph (b) of the proviso to section 54 (1) may sometimes be abused. Shares in the company might be vested in trustees who were, or were controlled by, the directors and the votes attached to those shares could be used to secure the directors' control over the company. We have considered the possibility of providing that the voting rights attached to shares vested in trustees pursuant to these provisions should not be exercisable unless the trustees were independent of the directors, but, in view of the difficulty this might involve for companies with profit-sharing schemes and the lack of any evidence that the abuse is at all common, we have rejected it.

187. **We recommend that:**

**(a) a limited company should be expressly prohibited from reducing its capital (in the sense in which that term is used in paragraph 157 above) and from purchasing its own shares save as provided in the Act;**

**(b) subsection (2) and subsection (3) of section 68 should be repealed**

(c) section 56 should be amended:

(i) to provide that a share premium arises whenever a company receives value for and in excess of the amount credited as paid up on shares of a par value issued in exchange and that such excess must be credited to the share premium account (where shares of no par value are issued, the total consideration received should be credited to the "stated capital account ");

(ii) so that it no longer permits the share premium account to be applied in writing off the expenses of, or the commission paid and discount allowed on, any issue of debentures or in providing for any premium payable on the redemption of debentures:

(iii) to make it clear that the expenses of an issue of shares include the capital duty paid on the creation of the shares, irrespective of when that capital duty is paid;

(d) section 54 should be re-cast:

(i) so that it makes it unlawful for a company to give financial assistance for the acquisition of its shares or those of its holding company unless the transaction whereby such assistance is given has been approved by a special resolution of the company and there has been filed with the Registrar of Companies a declaration or solvency on the lines indicated at paragraph 179 above;

(ii) to impose a substantial penalty for making a declaration of solvency without reasonable grounds, with a presumption that a declaration has been made without reasonable grounds if within 12 months of the filing of the declaration the company is wound up and its debts are not paid in full within 12 months of the commencement of the winding up;

(iii) to give a dissentient minority holding 10 per cent. or more of the shares of the company or any class of them the right, within 28 days of the passing of the necessary special resolution, to apply to the Court to prohibit the proposed transaction;

(iv) to require that unless the special resolution was passed with the approval of all members no transaction giving such assistance shall be carried out until the expiry of, say, 28 days after the passing of the necessary special resolution or (if application has been made to the Court in pursuance of the right recommended at (iii) above) the Court has approved the transaction;

(v) to impose a substantial penalty for any transaction effected in breach of the conditions mentioned at (i) above, such penalty being imposed on the directors or other officers in default, but not on the company;

(vi) to make it clear that neither the payment by the company of a dividend properly declared nor the discharge of any other lawful liability is to be regarded as the giving of financial assistance;

(vii) to make it clear that financial assistance is deemed to be given by a company if, within a period of, say, 12 months of the acquisition of a controlling interest in it, the company

purchases any asset from the controlling shareholders or from any company directly or indirectly controlled by them;

(viii) to provide that any transaction in breach of the conditions mentioned at (i) above shall be voidable at the instance of the company against any person (whether a party to the transaction or not) who has notice of the facts;

(e) provisos (b) and (c) to section 54 (1) should be extended for the benefit of employees of subsidiaries of the company concerned.

## CHAPTER VI

### MINORITIES

#### Protection of Special Classes of Shares

188. The articles of most companies contain a provision on the lines of Article 4 of Table A, under which the special rights attached to any class of share may be varied with the consent of a prescribed majority of the holders of shares of that class. Where there is no such provision the position is open to doubt; on one view such rights are unalterable except with the consent of every holder of the shares concerned or by means of a scheme of arrangement under section 206; the other view is that the special rights conferred by the articles can be varied by a special resolution of the company, subject, of course, to attack on the grounds of unfairness by shareholders of the class affected.

189. We think the position should be clarified and that the Act should be amended to provide that, if there is no provision in the articles relating to the variation of class rights and those rights are not conferred by the memorandum, the articles should be deemed to include a provision for the variation of such rights on the lines of Article 4 of the present Table A, amended in accordance with the following suggestions:—

- (a) it should be made clear that such rights cannot be varied unless the prescribed consent is obtained; (in some cases a special resolution altering the articles may also be necessary);
- (b) the provision should cover not only the variation, but also the abrogation of special rights;
- (c) it should be made clear that one person holding any number of the shares concerned may constitute a quorum at an adjourned class meeting.

190. In modern practice special rights are rarely attached to a class of shares by the memorandum. The view commonly held in England is that where such rights have been so attached they either are alterable only as provided in the memorandum or by articles expressly referred to therein or are unalterable except under a scheme of arrangement approved by the Court under section 206 of the Act. In the Scottish case of *Re Marshall Fleming & Co. Ltd.* 1938 S.C. 873, it was held that, even where a memorandum is silent as to the variation of rights but contemporaneous articles contain provision for variation, the rights conferred by the memorandum can be varied in accordance with that provision. Doubt has been expressed whether this decision would be followed in England. In our view the decision produces a reasonable result and it should apply in both countries alike. We think the present position is otherwise generally satisfactory; if rights are attached to a class of shares in the memorandum and no provision for the variation of those rights is made either in the memorandum itself

191. If a provision for the alteration of class rights is contained in the articles it should be made clear that any alteration of that provision is itself a variation of class rights. This principle should apply to the provision suggested at paragraph 189 above.

192. If the suggestions made in the preceding paragraphs are accepted we think section 10 of the Act should be correspondingly amended. That section provides that "subject to the provisions of this Act and to the conditions contained in its memorandum, a company may by special resolution alter or add to its articles". There is authority for saying that this power of altering the articles must "be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities." (See *Allen v. Gold Reefs of West Africa Ltd.* [1900] 1 Ch. 656, per Lindley, M.R., at p. 671). We think that section 10 should be qualified to indicate that the power to alter the articles by special resolution does not include the power to vary or abrogate class rights except in accordance with the provisions (express or implied by statute) of the articles relating to the variation or abrogation of those rights.

193. Section 72 of the Act gives a dissentient minority of a class of shareholders the right to apply to the Court to cancel a variation or abrogation of their class rights where a prescribed majority of shareholders of that class have agreed to the variation. We agree with those witnesses who say that the time for exercising this right is too short and that the shareholding prescribed for the minority is too large. In our view the time for making the application should be extended from twenty-one to twenty-eight days and the right should be exercisable by the holders of not less in the aggregate than ten (instead of fifteen) per cent. of the issued shares of that class. Section 72 (5) should also be amended to extend the period within which a copy of the Court's Order shall be forwarded to the Registrar from fifteen to twenty-one days. Under section 72 a shareholder who has assented to a variation of the special rights attached to his shares cannot apply to the Court for the variation to be cancelled. This can cause difficulty to a nominee who holds shares on behalf of a number of persons, for the fact that he has assented to a variation as the nominee of one of those persons deprives him of the right to apply, as the nominee of the other, for the variation to be cancelled. While we recognise that the condition is reasonable where a member holds all his shares beneficially or on behalf of one other person we do not think that there is a substantial likelihood of such persons applying to the Court, and we think that the difficulty of the nominee holding for different interests could best be met by repealing the condition.

194. The right given to a dissentient minority of a special class of shareholders by section 72 to some extent overlaps the right given to an aggrieved shareholder by section 210. We think that the special remedy given by section 72 should be preserved but we also think that it should

be made clear that this remedy does not derogate from the more general remedy given by section 210.

195. Some witnesses have suggested that the law should be altered to prohibit the repayment, by way of reduction of capital, of irredeemable preference shares except with the consent of the preference shareholders. We recognise that the cases of *Scottish Insurance Corporation Ltd. v. Wilsons and Clyde Coal Co.* [1949] A.C. 462; 1949 S.C. (H.L.) 90 and *Prudential Assurance Co. v. Chatterley-Whitfield Collieries Ltd.* [1949] A.C. 512, which decided that such consent was not legally necessary, roused strong feelings among preference shareholders generally and we sympathise with those investors who acquired preference shares on the assumption that they were irredeemable only to discover that they could be paid off at a time when it was impossible to re-invest their money except at substantially lower rates of interest than the preferential rate of dividend. After careful consideration, however, we have come to the conclusion that it would be wrong to alter the law. Since the two cases cited above were decided, preference shares which are quoted on the Stock Exchange have generally been issued on terms which adequately safeguard the interests of preference shareholders in the event of their moneys being returned either in a winding up or on a reduction of capital, by linking the redemption price to the average market price during the previous six months. These terms are expressed in a formula known as the Spens formula. Cases where the holders of preference shares so quoted are liable to be prejudiced by the return of their money in unfavourable circumstances must by now be comparatively rare and will become rarer. This, it is true, does not apply to unquoted shares, in particular shares in private companies for which the Spens formula is inappropriate. However, the proposed alteration in the law would have the effect of retrospectively altering contractual rights of some shareholders and for this, in the circumstances, we do not see sufficient justification.

196. The rights of preference shareholders are not always fully set out in the articles or in the terms of issue. It has been suggested that a new Companies Act should provide that if a company creates preference shares carrying a specified rate of dividend, then, unless the articles or terms of issue specifically provide otherwise, those preference shares should carry certain defined rights. We doubt the wisdom of attempting to define by statute the basic rights attaching to preference shares of which there are so many varieties.

197. As section 58 of the Act is now worded, it is impossible to convert issued preference shares into redeemable preference shares. It would often be convenient if companies had power to do this by special resolution, subject to any appropriate class consents being given.

198. We recommend that:—

- (a) where special rights are attached to a class of shares, otherwise than in the memorandum, and there is no provision in the articles for the variation of these rights, the articles should be deemed to include a provision on the lines of Article 4 of the current Table A, amended :

- (i) to make clear that special rights cannot be varied except with the consent of the prescribed majority of the holders of the shares concerned ;
  - (ii) to regulate the abrogation as well as the variation of the special rights ;
  - (iii) to provide that at an adjourned meeting of the holders of shares of the class concerned one person holding any of the issued shares of that class shall constitute a quorum ;
- (b) it should be made clear that the alteration of a provision relating to the variation of class rights is itself to be treated as a variation of those rights ;
  - (c) the Act should expressly provide that, where special rights are conferred upon a class of shares by the memorandum and provisions for the variation of special rights are contained in contemporaneous articles, such rights may be varied in accordance with those provisions, notwithstanding the fact that there is no reference to them in the memorandum ;
  - (d) section 10 of the Act should be amended to make it clear that a company's power to alter its articles by special resolution cannot be used to override the special rights attached to a class of shares ;
  - (e) section 72 of the Act should be amended—
    - (i) by increasing the time for an application by a dissentient minority from twenty-one days to twenty-eight ;
    - (ii) by permitting an application to be made by the holders of ten instead of fifteen per cent. of the issued shares of the class concerned ;
    - (iii) by increasing the time for forwarding a copy of the Court's Order to the Registrar from fifteen to twenty-one days ;
    - (iv) by deleting the words in subsection (1) "being persons who did not consent to or vote in favour of the resolution for the variation" ;
  - (f) it should be expressly provided that the remedy given by section 72 does not derogate from the remedy given by section 210 ;
  - (g) section 58 of the Act should be extended so as to permit the conversion of preference into redeemable preference shares by special resolution, subject to any appropriate class consents.

### **Protection of Minorities**

199. Two changes in the law designed to strengthen the position of minorities (primarily but not exclusively in private companies) were recommended by the Cohen Committee and in substance adopted in the 1948 Act. The first consisted of the amendment of the 1929 Act so as to prevent a contributory's petition to wind up a company from being defeated by the mere fact of the existence of an alternative remedy. The amendment designed to achieve this result is embodied in subsection (2) of the present section 225 which reads as follows:—

"Where the petition is presented by members of the company as contributories on the ground that it is just and equitable that the company should be wound up, the court, if it is of opinion,-

(n) that the petitioners are entitled to relief either by winding up the company or by some other means; and

(b) that in the absence of any other remedy it would be just and equitable that the company should be wound up;

shall make a winding-up order, unless it is also of the opinion both that some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy."

200. The second of the two changes above referred to consisted of the inclusion in the 1948 Act of section 210, which was entirely new. The substantive provisions of section 210 are contained in subsections (1) and (2) which read as follows:

"(i) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) or, in a case falling within subsection (3) of section one hundred and sixty-nine of this Act, the Board of Trade, may make an application to the court by petition for an order under this section.

(2) If on any such petition the court is of opinion-

(a) that the company's affairs are being conducted as aforesaid; and

(b) that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up;

the court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise."

Neither section 225 (2) nor section 210 appears to have produced the results expected of it. We make recommendations about section 225 (2) in Chapter XIV below. As regards section 210 the first reported case in which it was successfully invoked was that of *Meyer v. Scottish Textile and Manufacturing Co. Ltd.* 1957 S.C. 110 affirmed in the House of Lords under the name of *Scottish Co-operative Wholesale Society Ltd. v. Meyer* [1959] A.C. 324; 1958 S.C. (H.L.) 40, and followed by the Court of Appeal in England in *Re H. R. Hatmet Ltd.* [1959] 1 W.L.R. 62. The views expressed in those decisions as to the scope and effect of the section have undoubtedly given applications made under it a better prospect of success. Many witnesses have, however, expressed the opinion, with which we agree, that even as interpreted in the two cases to which we have just referred the section as it stands calls for amendment if it is to afford effective protection to minorities in circumstances such as those with which it is intended to deal.

201. The first and most important respect in which the section is said to require amendment concerns the reference to winding up contained in subsection (2) (b). The effect of this is that the applicant in order to succeed must show not only that the company's affairs are being conducted in a manner oppressive to some part of the members (including himself) within the meaning of subsections (1) and (2) (a), but also under 2 (b) "that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding up order on the ground that it was just and equitable that the company should be wound up." It is pointed out that a case for winding up under the just and equitable rule at the instance of a contributory is difficult to establish and it is suggested that there is no sufficient reason for making the establishment of such a case an essential condition of intervention by the Court.

202. A second major criticism is to the effect that the basic condition of relief under the section, viz. "that the affairs of the company are being conducted in a manner oppressive" etc., indicates a course of conduct as distinct from an isolated act. It is also suggested that "oppressive" is too strong a word to be appropriate in all the cases in which applicants ought to be held entitled to relief under the section.

203. In *Meyer's case (supra)* Lord Simonds, in discussing the meaning of "oppressive" adopted the dictionary meaning of "burdensome, harsh and wrongful". This is probably as good a definition as any other which could be devised, but it is to be observed that a question remains as to the degree of culpability required to satisfy the element of "wrongfulness". Does it postulate actual illegality or invasion of legal rights or is it satisfied by conduct which without being actually illegal could nevertheless be justly described as reprehensible. The outcome of *Meyer's case* indicates the broader view. And in our view, if the section is to afford effective protection, it must extend to cases in which the acts complained of fall short of actual illegality.

204. In *Elder v. Elder & Watson Ltd.* 1952 S.C. 49, it was said by Lord Cooper (at p. 55) with reference to the meaning of oppression in section 210 "the essence of the matter seems to be that the conduct complained of should at the lowest involve

a visible departure from the standards of fair dealing, and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely". This statement accords with our own view as to the intention underlying section 210 as originally framed, namely that it was meant to cover complaints not only to the effect that the affairs of the company were being conducted in a manner oppressive (in the narrower sense) to the members concerned but also to the effect that those affairs were being conducted in a manner unfairly prejudicial to the interests of those members. We think that the section should be amended to make this clear, and also to make it clear that it is to cover particular acts which are oppressive to or unfairly prejudice the interests of the complaining members as well as to courses of conduct having those effects.

205. As the Cohen Committee observed in paragraph 60 of their report, it is impossible to frame a recommendation to cover every case, and we do not propose to attempt to do so. But we may perhaps usefully mention as illustrative of the situations in which action under section 210 might be appropriate those in which directors appoint themselves to paid posts with the company at excessive rates of remuneration, thus depriving the complaining members of any dividend, or any adequate dividend, on their shares; or in which the directors, having power to do so under the articles, refuse to register personal representatives in respect of shares devolving upon them in that capacity, and by this expedient (coupled with the absorption of profits in payment of the directors' remuneration) force the personal representatives to sell their shares to the directors at an inadequate price. Other possibilities are the issue of shares to directors and others on advantageous terms; and the passing of non-cumulative preference dividends on shares held by the minority.

206. In addition to these direct wrongs to the minority, there is the type of case in which a wrong is done to the company itself and the control vested in the majority is wrongfully used to prevent action being taken against the wrongdoer. In such a case the minority is indirectly wronged. In certain special cases, such as those arising from an illegal or *ultra vires* act, a member of the company may sue to remedy the wrong, but, generally speaking, under the rule in *loss v. Harbottle*, the company alone can sue for a wrong done to it. To that general rule there is an exception under which a member may sue if, but only if.

(a) the wrong alleged to 'have been done to the company is of a fraudulent character; and

(b) he can show that the control vested in the majority is being, or will be, used to prevent the company from suing, in such a way as to constitute a "fraud on the minority".

It has been represented to us that conditions (a) and (b) are too restrictive, since the company's omission to sue may be unfair to the minority even if the wrong done to the company is not fraudulent and since the plaintiff may find it very

difficult to prove both that the defendants control the company and that there is a "fraud on the minority " - a notoriously vague concept. We think there is justice in this criticism, but we think it would be extremely difficult to devise a satisfactory general provision expressing the exception to the rule in *Foss v. Harbottle* in wider terms. On the other hand we think that if the proposal we make at paragraph 204 above is accepted and section 210 is extended to apply not merely (as now) to a course of conduct which is oppressive 'but to isolated acts of an oppressive character, it should go some way to providing a shareholder who suffers an indirect wrong of the kind described above with a more effective remedy than he enjoys at common law. We think, however, that for this purpose section 210 should be further extended to give the Court an express power, if upon hearing a petition under that section it sees fit, to authorise proceedings to be brought against a third party in the name of the company by such person or persons and on such terms as the Court may direct. We think that the power thus given to the Court should be without prejudice to the powers of the Board of Trade under section 165 (b) (i) to appoint an inspector where it appears to the Board that there are circumstances

suggesting that the business of a company is being carried on in a manner oppressive of any part of its members.

207. It has been suggested that there may be a danger, in extending the courses of action open to a minority shareholder in this way, and indeed, one of our American witnesses, Mr. G. A. Brownell, admitted that they had been abused in the United States. He nevertheless expressed the opinion that "I believe it is correct and wise that minority stockholders' actions can be brought on behalf of the corporation against the directors, not only in cases of fraud but in cases of negligence, waste of corporate assets and so forth. Generally speaking, the right of stockholders to bring actions in such cases has a good effect in our corporate law, despite the fact that it often is abused."

It is not our intention to encourage litigation in cases in which, for instance, an independent majority has reached a bona fide decision to the effect that in the interests of the company as a whole no action should be taken. But we think that the discretion we propose should be given to the Court in such cases and the probable liability for costs of an unsuccessful litigant will be sufficient safeguards against abuse.

208. It has also been suggested, and we agree, that provision should be made in section 210 to enable the Court to restrain the commission or continuance of any act which would suffice to support a petition under the section.

209. The position of legal personal representatives and other (e.g. trustees in bankruptcy) to whom shares are transmitted by process of law, but who are not registered as members, would be improved by an express provision in section 210 entitling them to present a petition under that section, so as to place beyond doubt their rights in this respect, which appear as the law now stands to be open to question, and we think section 210 should be amended accordingly.

210. The General Council of the Bar rightly attach importance to the improvement of the somewhat precarious position of personal representatives of deceased shareholders when the directors have and exercise an absolute power to refuse to register them as members. They propose that any new Companies Act should include a section providing (in effect) that notwithstanding anything in the articles, if the directors of a company refuse to register the legal personal representatives of a deceased member in respect of any shares, the latter may require the directors to furnish a statement in writing of their reasons for refusing registration, and unless the directors furnish such a statement within a reasonable period, they shall be bound to effect the registration (subject to a proviso saving the rights of members entitled to pre-emptive rights over, or rights of purchasing, the shares affected). We think this is a valuable suggestion, since it would enable the legal personal representatives to institute proceedings, under section 116 for rectification of the register, whereas at present they are in great difficulty in doing so in the absence of knowledge of the directors' reasons for refusing registration.

211. Finally, we have considered whether the many complaints and criticisms we have received about the operation of restrictions on share

transfers in private companies might be met to some extent by the inclusion in Table A of a model article setting out reasonable and fair regulations about this matter. In our view, however, the question is not how the articles are drafted but how the discretion usually conferred upon the directors is exercised. We have come to the conclusion that it would not be reasonable to fetter the discretion usually given to the directors of private companies by conferring upon all transferees the right to demand reasons for refusal to register which we recommend should be given to personal representatives. To do so would limit a discretion which may be essential to preserve the character of a private company in order to provide against occasional abuse.

212. We recommend that:

(a) section 210 (2) (b) should be repealed;

(b) section 210 should be amended to make clear that it covers isolated acts as well as a course of conduct;

(c) it should be made clear that section 210 extends to cases where the affairs of the company are being conducted in a manner unfairly prejudicial to the interests of some part of the members and not merely in an "oppressive" manner;

(d) provision should be made enabling the Court to restrain the commission or continuance of any act which would suffice to support a petition under section 210;

(e) section 210 should be extended to give the Court an express power, where it thinks fit, to authorise the bringing of proceedings in the name of the company against a third party on such terms as the Court may direct;

(f) section 210 should be amended to make clear that legal personal representatives and others to whom shares are

transmitted by process of law, but who are not registered as members, are entitled to present a petition or seek an injunction under that section;

(g) legal personal representatives should be entitled to require the directors to furnish a statement in writing of their reasons if they refuse registration of such representatives; and if the statement is not furnished within, say, 28 days of the request for it the directors should be bound to effect the registration; there should be a proviso, saving the rights of any members entitled under the articles to any pre-emptive rights over, or rights of purchasing, the shares in question.

#### **Board of Trade's Powers to appoint Inspectors**

213. The Board of Trade are empowered to appoint an inspector to investigate the conduct of a company's affairs by sections 164 and 165. Certain ancillary powers and obligations are conferred by sections 166 to 170. Under section 164 the Board of Trade may appoint an inspector on the application of a prescribed number of members or of members holding a prescribed proportion of shares. The application "shall be supported by such evidence as the Board of Trade may require for the purpose of showing that the applicants have good reason for requiring the investigation."

Under section 165 (a) the Board of Trade must appoint an inspector upon a special resolution of the company concerned or an order by the Court to that effect. Under section 165 (b) the Board of Trade may appoint an inspector "if it appears to the Board that there are circumstances suggest-gag" intention to defraud creditors or fraud, misfeasance or other misconduct towards the company or its members, or oppression of a minority, or that the members of the company have not been given all reasonable information. The Board of Trade have informed us that:

"it is their practice in dealing with applications for the appointment of inspectors to ask an applicant who can command the support necessary for a section 164 application, or a complainant asking the Board of Trade to appoint an inspector under section 165 (b), to submit a Statement of Facts, verified by statutory declaration, setting out fully the reasons for requiring an investigation. With the consent of the applicant a copy of the Statement of Facts is sent to the company for the observations of the directors, ff the Board of Trade think it desirable these observations, with the consent of the directors are sent to the applicant/complaints so that the Board of Trade may have the advantage of the comments of the complainant upon the directors' answers but it is usually possible to form an opinion upon the merits of a case after one exchange of statements and observations. Although this method is open to criticism on the grounds of delay which is inevitable when the allegations are numerous and complicated and it is even suggested at times that we are conducting an investigation before the inspector be appointed, it is, however, in our experience very necessary to hear both sides before deciding whether or not an inspector should be appointed. By so doing it is often possible in cases in which no fraud is alleged to bring the parties together or for them to reach a mutually satisfactory arrangement so that an investigation is not necessary."

214. Critics of the present provisions and of their implementation by the Board of Trade complain particularly of the difficulties and delays involved in the appointment of inspectors. First, they criticise the Board of Trade's present practice of passing the Statement of Facts required from an applicant to the directors of the company concerned for their comments. They point out that this procedure not merely forewarns the directors of the precise nature of the

complaints and thus gives them ample opportunity if they are so minded to destroy or fabricate evidence before the appointment of an inspector, but also, on occasion, leads to lengthy delays while the directors compose their reply. Secondly, the complaint is made that if the applicants for an inspection have few facts to support their suspicions the Board of Trade are likely to send them away empty-handed with the explanation that inspections cannot be set on foot on the basis of vague suspicions. If, on the other hand, the applicants present a substantial *prima facie* case, they are likely to be told that they already have sufficient information to institute proceedings against the directors and that the appointment of an inspector is therefore not appropriate.

215. We fully appreciate the difficult position in which the Board of Trade are placed. The appointment of an inspector to investigate the conduct of a company's affairs is a serious step which can have serious consequences for the company and its members, even when the complaints are eventually shown to be entirely without foundation. Suggestions have been made to us for making the appointment of an inspector less harmful

to the company investigated, so that the Board of Trade might feel freer to appoint inspectors. It has been suggested, for example, that there should be two kinds of investigation, one where criminal activities were suspected and another, which would not carry the stigma of the former, where misfeasance or oppression were suspected. We do not believe that a division of this kind - even if it could be applied in practice, which we doubt - would really avoid, in non-criminal cases, the stigma associated now with the appointment of an inspector. It has also been suggested that damage to companies might be reduced if the Board were to appoint inspectors without giving public notice of the fact. The Board of Trade already have power to appoint inspectors without public notice and we understand that, in the case of private companies, this course is generally followed. But we do not think that in practice inspections of public companies could be conducted without giving rise at some stage to rumours; and, in any event, we think that shareholders and potential shareholders of public companies have a right to know when an inspector has been appointed. We have come to the conclusion that nothing can be done to prevent the appointment of an inspector causing some damage to a company. We do, however, believe that the Board of Trade would find it easier to decide when an inspection is justified - and therefore be less likely to be inhibited from appointing inspectors by fear of causing unnecessary damage - if they had power to obtain documents and information from companies under suspicion with a view to deciding whether or not to appoint an inspector. The provision of such powers would have the further advantage that the Board of Trade would be able to test the complainants' Statement of Facts without necessarily revealing to the directors the case against them and without the delays sometimes involved in awaiting the directors' reply.

216. As regards the second main burden of complaint, we think it should be made somewhat easier than it now appears to be for a complainant to set an inspection on foot, though we do not agree with those who think that the Board of Trade should be expected to appoint an inspector when the complainant already has sufficient evidence to take proceedings to assert his rights. Further, there appears to us to be an unnecessary overlap between sections 164 and 165 (b). In practice we understand that the Board of Trade almost invariably proceed under section 165 (b) after receiving a complaint, and we think it would lead to clarity if the powers to appoint inspectors, both mandatory and permissive, were set out in a single section and without the present overlap.

217. Several subsidiary points have also been brought to our notice, and we mention here briefly those which we think require attention. First, it has been suggested that an inspector appointed to investigate the affairs of a company should be able to investigate the affairs of any other company if he thinks this is necessary for the proper investigation of the first company. Section 166 at present enables him, in these circumstances, broadly speaking to investigate the affairs of a subsidiary, fellow-subsubsidiary or holding company of the first company. We recommend below that the Board of Trade should be given an additional power to appoint inspectors to investigate the affairs of a company on the ground that it is necessary for the purpose of the inspection of another company already pending. Secondly, the Act does not in terms require the preservation of documents

by the company's officers when an investigation is to be made. We recommend that this should be expressly required. Thirdly, section 168 requires the Board of Trade to send a copy of the inspector's report to the company investigated. The Board has pointed out to us that where criminal proceedings are contemplated or have been instituted as a result of such investigation the requirement to send a copy of the report to the company could well be embarrassing. We think the Board should have power to withhold a report if they think fit. Fourthly, section 169 (2) provides that where the Director of Public Prosecutions considers that the case is one in which a prosecution ought to be instituted, it shall be the duty of all officers and agents of the company to give the Director all assistance in connexion with the prosecution which they are reasonably able to give. In our view, this duty should also be imposed in cases where proceedings are instituted by the Board of Trade. Finally, section 170 provides that in the case of investigations under sections 164 and 165 (a) the Board of Trade can, at their discretion, recover the costs of the investigation from the company whose affairs have been investigated (or, where appropriate, from the applicants), except where a prosecution has been instituted by the Director of Public Prosecutions or the Lord Advocate as a result of the investigation. These provisions follow the recommendations of the Cohen Committee who apparently considered that where the investigation resulted in a prosecution the costs should fall on public funds, unless the Court ordered payment by the convicted offender. We think that in general this is right. But the Board of Trade have pointed out that an order for payment of the costs of an investigation by the convicted defendant is usually of little value since he seldom has sufficient means to meet them. On the other hand, the report may prove valuable in civil proceedings (against others than the convicted defendant) and may thus be of considerable financial advantage to the company. In such circumstances we see no reason why the company should not contribute to the costs of the investigation and we would leave it to the discretion of the Board of Trade to exact costs from the company (or applicants) where a prosecution has been instituted as a result of the investigation in the same way that it is left to the discretion of the Board in other cases.

218. We recommend that:

(a) section 165 (a) should be extended in scope so as to require the Board of Trade to appoint an Inspector when over 200 members or holders of one-quarter or more of the issued shares of any class, or, in the case of a company not having a share capital, one-quarter or more of the members request such appointment, unless the Board of Trade consider that the application is vexatious or that sufficient facts are known to the applicants to enable them to assert their rights on their own behalf;

(b) section 164 should be repealed. Applications for an inspection by a lesser number of members than prescribed in (a) above and by any other class of applicant, should be considered by the Board of Trade under section 165 (b);

(c) the Board of Trade should be expressly empowered to obtain documents and information from the directors and officers of

companies in respect of which applications for inspections are made to them, or in respect of which it otherwise appears to the Board that there are circumstances suggesting that any of the conditions described in section 165 (b) may be present;

(d) the Board of Trade should not regard themselves as bound to forward a Statement of Facts provided by the complainant to the company complained against. In considering whether an inspector should be appointed, when they have discretion in the matter, the Board will be able to rely instead on the information obtained under the powers recommended in (e) above;

(e) section 165 (b) should be extended to empower the Board of Trade to appoint inspectors to investigate the affairs of a company if it appears to the Board that it is necessary for the purpose of the inspection of another company already pending;

(f) the preservation of documents should be statutorily required from the moment that the Board of Trade inform the company either that they propose to make a preliminary investigation (see our recommendation (c) above) or appoint an inspector;

(g) section 168 should be amended to give the Board of Trade discretion to decide whether or not to forward a copy of any report made by the inspector to the registered office of the company;

(h) section 169 should be amended to impose in cases where proceedings are instituted by the Board of Trade a duty on all officers and agents of the company to give all assistance to the Board in connexion with the prosecution which they are reasonably able to give;

(i) section 170 (1) (c) should be amended by the deletion of "unless as a result of the investigation a prosecution is

instituted by the Director of Public Prosecutions or by or on behalf of the Lord Advocate."

## CHAPTER VII

### THE PROTECTION OF INVESTORS

219. Under this general heading we propose to discuss the protection afforded by existing law and practice to persons who may be invited to subscribe for or buy, sell or exchange securities of a company, and various suggestions which have been made for the improvement of such protection.

220. To put the general position very briefly, any offer by or on behalf of a company of securities to the public for subscription or sale must be accompanied by a prospectus which must contain the information prescribed by the Act: (section 38 and Fourth Schedule, section 45). If an official quotation is to be granted by the Stock Exchange, the prospectus must also comply with more exacting requirements imposed by the Stock Exchange rules. The Stock Exchange does not concern itself with issues for which an official quotation is not sought, and is naturally averse from doing so. On the other hand, where a prospectus states that an official quotation will be sought, and such quotation is not obtained, statutory provision is made for the avoidance of any allotments and the return of money subscribed (section 51).

221. It is common practice for new issues to be made by way of offers of rights to existing members or debenture holders. Prospectuses containing such offers are not required to set out the detailed information specified in the Fourth Schedule. Offers to the public of securities identical with those already dealt in or quoted on a prescribed stock exchange are similarly exempted. The Stock Exchange, however, in both cases normally requires the circulation of up to date information.

222. Cases in which an official quotation is not sought and which accordingly are outside the domestic jurisdiction exercised by the Stock Exchange are subject only to the statutory protective provisions and not to those of the Stock Exchange, and thus escape the rigorous scrutiny insisted on by the Stock Exchange in quoted cases. But issues for which a

quotation is not sought are in practice rare, and apart from issues of loan capital are usually relatively unimportant in amount, and the statutory requirements in themselves afford a by no means negligible degree of protection. Be that as it may, it seems to us that the existing disparity in point of protection between quoted and unquoted issues does demand attention, and we make certain recommendations about it below in the section dealing with prospectuses.

223. Dealings (including "take-over bids") in shares already issued, as distinct from new offerings, are governed up to a point by the Prevention of Fraud (Investments) Act, 1958, and the Licensed Dealers (Conduct of Business) Rules, 1960, made under that Act, the effect of which is discussed in some detail below.

connected with new issues, is at all times able to adapt and strengthen its requirements to meet individual cases and changing trends and the important supervisory functions which it performs are by no means confined to the approval of new issues: it also uses its powers of revoking quotations granted in respect of issued shares where this appears necessary for the purpose of checking undesirable developments.

225. Reference should also be made to the part played by the Issuing Houses through whom most new issues of any importance reach the public and who are concerned, for their own credit, to see that proper standards are maintained. It may be added that counsel, solicitors, and accountants consulted with respect to the preparation of the necessary documents are bound as a matter of professional duty to do their best to see that all is right.

226. To conclude our brief summary of the protection at present enjoyed by investors, we would observe that the directors and others mentioned in sections 43 (1) and 44 (1) of the Act expose themselves to the risk of civil liability under the former, and criminal liability under the latter section in respect of any untrue or misleading statements in prospectuses in the issue of which they have been concerned. Reference should also be made to section 13 of the Prevention of Fraud (Investments) Act which imposes a penalty for fraudulently inducing persons to invest money; to section 84 of the Larceny Act. 1861, which makes it a misdemeanour for a director or other officer of a company to circulate a statement knowing it to be false in any material particular with intent (*inter alia*) to induce any person to become a shareholder in a company; and to the civil liability incurred for deceit at common law and for breach of the statutory duty imposed by section 38 of the Companies Act.

227. The present system is accepted by most Of our witnesses as working well in practice and the various statutory requirements, supplemented by the Stock Exchange rules, appear to us sufficient, provided they are duly complied with, as apart from rare exceptions they are, to ensure that adequate disclosure of material matters is made in prospectuses. The system has, however, been criticised in some quarters on the ground that it provides no central and independent statutory body or authority charged with the duty of scrutinising all

facts and documents bearing upon proposed issues of shares or debentures, and invested with power to stop any issue of which they do not approve. It is pointed out that the Registrar of Companies is under no duty to satisfy himself as to the merits of the projects envisaged by the prospectuses and accompanying documents which he receives for filing, or to ensure that all relevant considerations are fairly stated therein, but is merely concerned to see that these documents comply in point of form with the requirements of the Act. It is pointed out further that (as we have already said) the Stock Exchange, in exercise of its domestic jurisdiction, will only accept responsibility for seeing that shares or debentures for which an official quotation is sought, or which already have such quotation, are fit to receive or retain it, and will not concern itself with the adequacy or otherwise of documents offering securities for which a quotation is not intended to be sought. Thus it may be argued

that the one effective sanction possessed by the Stock Exchange (viz. the refusal or suspension of official quotations) is by definition incomplete, and less effective than a plain statutory power, vested in an independent body, of stopping undesirable offers.

228. It seems to us that in theory there is a good deal to be said for the independent statutory body. The system of control obtaining in the U.S.A. is based upon such a body in the shape of the Securities and Exchange Commission (S.E.C.), and we would record once more our indebtedness to the distinguished witnesses from the U.S.A. who explained their system to us with admirable clarity and precision. That system has been shown by experience to be well suited to U.S.A. conditions, and the U.S. witnesses pronounced it a success for the most part. However, they also pointed out that the conditions affecting the issue of shares to the public in this country, and the methods of issue, are radically different from those in the United States. In the memorandum which they prepared for us the law firm of Davis Polk Wardwell Sunderland and Kiendl wrote:

"Whether or not such a Commission would be a desirable adjunct to the British system is a question that we obviously are not qualified to answer. It seems to us, however, that among the factors that were responsible for its creation there are at least two that have no counterparts in Britain. When in 1933 it became apparent that our securities laws needed strengthening we did not have in existence any nation-wide machinery. There are active, securities markets in various locations in the United States, and we have no single stock exchange like the London Stock Exchange whose effective controls operate throughout the country. Furthermore, the bulk of our new securities issues are not listed, whereas in England we understand that listing on the London Stock Exchange is a practical prerequisite in the case of a new issue. Secondly, the size of this country, its scattered security markets, the existence of 50 separate state governments and the past history of the securities business made strong centralised control in Washington important."

We are not persuaded that a system of control on the U.S. model would work as well in this country as the more flexible though perhaps theoretically less perfect system which has

grown up here over the years. But, given the wider devolution of control inherent in the British system, it seems to us that the present arrangement may be open to criticism on the ground that there is inadequate co-ordination of the experience and views of the Board of Trade and of the other bodies concerned with protection of the investor.

229. The Cohen Committee recommended, in paragraph 176 of their Report, that a committee would be useful to advise the Board of Trade on matters arising in the administration of the Company Act. Following this recommendation two committees have been established by the Board of Trade, the Companies Act Consultative Committee and the Accountancy Advisory Committee. We think that the Consultative Committee, perhaps with wider terms of reference and meeting at regular intervals, could well provide the machinery of coordination and co-operation which we hope will be established.

230. If, as we recommend below, the Board of Trade were given rule-making power on the requirements in regard to prospectuses and to take-over offers, the Board of Trade might ask the Committee to advise them

from time to time on possible improvements in the law, and if thought fit implement such suggestions by recourse to the rule-making power where they fall within its scope. We do not propose that the Consultative Committee should normally concern itself with amendments to the Acts themselves (as distinct from the exercise of the Board's powers under the Acts) - this function we think, is better left as hitherto to a periodical review by a Departmental Committee. Nevertheless the Consultative Committee would, we hope, be free to advise amendments to the Acts if they thought such action was urgently required. Suggestions relating to the operation of the Stock Exchange might also emerge from time to time and be brought to the notice of the Stock Exchange for such action as it might consider desirable.

231. It has been suggested to us that the existing provisions relating to issuing and dealing in securities in the Companies Act, 1948, and the Prevention of Fraud (Investments) Act, 1958, might with advantage be consolidated in one Act. This might be done by combining with the provisions of the present Companies Act relating to prospectuses and offers for sale the provision, now contained in the Prevention of Fraud Act with respect to the distribution and contents of circulars. The provisions as to Unit Trusts might at the same time be transferred to a new part of the Companies Act, leaving in the Prevention of Fraud (Investments) Act only the provisions relating to the business of dealing in securities.

232. In order to reach a decision for or against the adoption of any proposed form of consolidation it would be necessary to make a detailed study of the relevant provisions of the two Acts, and to weigh the advantages in the way of simplification to be expected from the proposed consolidation against the disadvantages inherent in the extensive re-arrangements and amendments likely to be involved, which might in practice be found to eliminate old difficulties at the expense of creating new ones. We have not thought it right to embark upon a detailed investigation of this kind, and would only say that if it were found to be practicable we would welcome a consolidation on the lines discussed above.

233. It has been represented to us that uninformed members of the public may be misled by advertisements and circulars which state the amount of the authorised or issued capital of the

companies to which they refer without stating the amount of paid up capital. We think there may be a real danger here and that any company which issues an advertisement or a circular to the public stating the amount of its authorised or issued capital should be required also to state the amount of its paid up capital.

234. We recommend that:

(a) the Companies Act Consultative Committee should meet regularly to co-ordinate the experience of the various bodies concerned with the protection of investors; the Committee should advise the Board of Trade of changes which they consider desirable in the administration of the law (including the use of the Board's rule-making powers) or in current practice to protect the investor; the Committee should also be free to advise amendments to the Acts if they thought such action was urgently required;

(b) if practicable, the law should be consolidated by transferring to the Companies Act the provisions relating to the distribution and contents of circulars, and those relating to Unit Trusts, contained in the Prevention of Fraud (Investments) Act;

(c) any company which issues an advertisement or circular to the public stating the amount of the company's authorised capital or issued capital should be required also to state therein the company's paid up capital.

### **Prospectuses**

#### *Definition*

235. The essential feature of a prospectus for the purposes of the Companies Act is that it is a document inviting the public to subscribe for or purchase shares or debentures of a company, it is notoriously difficult to define "the public" and the Act does not attempt to do so. Some guidance is given, however, by section 55 which indicates the circumstances in which offers are or are not to be regarded as made to the public. We are aware that the section has been criticised but our impression is that it has worked well enough in practice and we would deprecate any sweeping revision of its terms.

236. It is generally accepted that "subscription or purchase" involves the payment of money and accordingly that a document containing an offer of securities for a consideration other than cash (e.g. shares) cannot be a prospectus although it may be a circular to which the Prevention of Fraud (Investments) Act applies. Where an offer of securities for shares is made in a take-over offer, the take-over rules (which we propose below should be applied to all take-over offers) will require information to be given about the securities which are being offered and section 13 of the Prevention of Fraud (Investments) Act will protect investors against the circulation of misleading information about them.

237. We think that the definition of prospectus should be extended to cover documents offering securities for a consideration other than cash but, where securities are offered in exchange for others in a take-over offer, compliance with the take-over provisions should be deemed to be sufficient compliance with the requirements as to prospectuses in the Companies Act.

#### *Applications and allotments*

238. Section 50 (1) of the Act provides that no securities shall be allotted in pursuance of a prospectus issued generally until the beginning of the third day after that on which the prospectus is first so issued or such later time (if any) as may be specified in the prospectus. The purpose of this provision, which is based on a recommendation made by the Cohen Committee, was to give the Press time to comment and the general public an opportunity to apply for securities and obtain expert advice before doing so. The provision has been criticised on the ground that the interval of two days is not long enough for its purpose; in view, however, of the wide fluctuations that might occur in the market and the possibility of speculative transactions outside the Stock Exchange, we do not think

it would be reasonable to extend this interval. The provision has also been criticised on the ground that it does nothing to ensure that all applicants are treated alike when the allotments are made. We do not think it would be possible to devise statutory rules to achieve this end, and, in any case, we understand that it is the practice of the banks and issuing houses to ensure that if an issue is over-subscribed, allotments are fairly made.

239. Section 50 (5), which is also based on a recommendation made by the Cohen Committee, provides that applications made in pursuance of a prospectus issued generally shall not be revocable until after the expiration of the third day after the time of the opening or the subscription lists. It has been represented to us that this interval is not long enough. We think there should be a reasonable interval during which the persons responsible for making allotments should be free to carry out their duties unembarrassed by the danger that offers may be withdrawn before it has been possible to issue a formal letter of allotment to the applicant. There is some doubt about the period during which an application remains irrevocable under section 50 (5) as it now stands. We suggest that the law should be amended to provide that applications made after the date of issue of a prospectus issued generally should immediately become irrevocable and remain so until the expiry of seven working days after the day on which the prospectus is first so issued. We understand that allotments of securities for which a quotation on the London Stock Exchange is sought are invariably made as soon as possible after the time prescribed in section 50 (1), i.e. the beginning of the third day after that on which the prospectus is first issued generally. In practice, therefore, the effect of our suggestion will be that the application will generally remain irrevocable until the expiry of the fifth instead of the third day after the time of the opening of the subscription lists.

240. Although the Act provides that securities may not be allotted in pursuance of a prospectus issued generally until the opening of the subscription lists, it does not prescribe a time after which allotments may not be made in pursuance of a prospectus so issued. We do not think that any statutory provision is necessary in relation to securities for which a quotation on a prescribed stock exchange is being sought; on the other hand we have been informed of cases in which securities for which such a quotation has not been sought have

been offered to the public generally and have remained "on tap" for an indefinite period in reliance on a prospectus containing information which may well have become obsolete or misleading. We think this is unsatisfactory and suggest that a general time limit of, say, three months, should be imposed.

241. In Chapter IX we recommend 'that "open-ended" investment companies should not be permitted to be incorporated in this country, since we think it unnecessary to introduce the complex legislation which would be needed to control such companies. For the same reason we recommend there that open-ended companies, incorporated abroad, should not be permitted to circulate generally in this country a prospectus offering securities for subscription. The provisions of the Fourth Schedule are not adapted to meet the circumstances of such companies and we do not

think it would be practicable to adapt them to provide adequate safeguards for investors in the absence of any general control over the activities of such companies.

242. By virtue of section 50 (7) the provisions of section 50. described above, do not apply to offers in respect of which an exemption has been granted under section 39. We me no reason why they should not apply to such offers and would accordingly repeal section 50 (7).

#### *Information to be given*

243. The information required to be given in a prospectus to which section 38 of the Act applies is specified in the Fourth Schedule. We have received many suggestions for supplementing the information so required. We are reluctant to add to the bulk and complexity of prospectuses but we think the requirements of the Fourth Schedule should be extended in the following respects. First, we agree that information, on the lines of that now required by the London Stock Exchange, should be required in respect of the matters specified in paragraph 252 (e) below. Secondly we think that turnover should be disclosed. In Chapter X we recommend that companies should be required to disclose turnover in their accounts because this information can provide investors with a useful guide to the progress of the business, but we make provision for any exceptional case where the directors consider and state that this would be harmful to the company. We do not think such an exception should be provided in respect of prospectuses: if a company chooses to invite the public to subscribe for its securities the latter should always be entitled, in our opinion, to this guide to the company's affairs. We would however make a narrowly drawn exemption on the lines of that recommended as regards disclosure in annual accounts for companies such as banks and discount houses in respect of which disclosure of such figures would not be useful. Turnover should be given in respect of the five financial years immediately preceding the issue of the prospectus, but transitional provisions will be necessary to provide for cases where companies do not have the information.

244. The third respect in which we think that the provisions of the Fourth Schedule should be extended is in relation to the information to be given where debentures are offered: we think that prospectuses relating to debentures should be required to give information about such matters as interest, terms of redemption and security offered.

245. Finally, we suggest that the Board of Trade should have power to amend by statutory instrument the Fourth Schedule to the Companies Act, which sets out the information to be contained in prospectuses. We hope that the Board of Trade will use this power, in consultation with the Consultative Committee to which we have already referred, to keep the Fourth Schedule up to date.

*Broadcast and cinematograph advertising*

246. Our attention has been drawn to the dangers of permitting invitations to subscribe for or purchase or sell securities, to be made by means of wireless or television broadcasting or cinematograph advertising. As regards such invitations made in the United Kingdom, a practical problem

arises at present only in relation to commercial television. We have seen the rules made by the Independent Television Authority relating to this matter; their effect is to prohibit the issue of any invitation to subscribe for or purchase any but a small list of Government and similar securities, and to prohibit the issue of any advertisement containing any review of or advice about the stock market or investment prospects, or which offers to advise on investments; references to the publication of prospectuses in newspapers and journals may be made, provided that they are strictly limited to giving the name of the company whose securities are being offered, the amount of the offer and the names and dates of the publications in which the prospectus may be found. These rules seem to us to provide adequate safeguards against abuse and we do not see any present need for further statutory rules. We have not made any enquiries about the rights of the Board of Trade to be consulted by the Independent Television Authority on the rules regulating these broadcasts; but we think the Board of Trade should be in a position to insist that these rules are adequate and to this end we suggest that the Board of Trade should be empowered under the Companies Act to make any rules that may be necessary to control the advertisement through any of these media of invitations to subscribe for or purchase or sell securities.

*Statement in lieu of prospectus*

247. The provisions now contained in section 48 of the 1948 Act whereby a company which has not issued a prospectus on or with reference to its formation, or has issued such a prospectus but has not proceeded to allotment upon it, is prohibited from proceeding to its first allotment of securities until it has filed a statement in lieu of prospectus, were originally introduced in substantially similar terms by the Act of 1908 on the recommendation of the Loreburn Committee which reported in 1906. The Loreburn Committee suggested these provisions to meet a practice which had grown up of disposing of large blocks of a company's securities by means of placings which resulted in the securities in fact reaching the public from the original allottee without any offer to the public and therefore without any obligation on the company to provide the public with prospectus information. They seem to have had their doubts as to the efficacy of the proposal, for at page 7 of their Report they said:

"Without being very sanguine as to the practical usefulness of such a statement the majority of us are of opinion that it would be desirable to require such a statement to be made and filed with the Registrar ..."

These doubts appear to have been justified by subsequent experience, for we are assured that the statement in lieu of prospectus has been found in practice to be of little or no value. In any case, the gaps which they were concerned to stop have since been largely stopped in other ways. Sections 45 (which covers offers for sale) and 55 (which covers placings) of the Act of 1948 now require prospectus information to be given in the kind of case to which the Loreburn Committee referred. Moreover the Prevention of Fraud (Investments) Act now controls offers of securities to the public so far as they are not covered by the prospectus provisions. Furthermore, those public companies whose securities are quoted are required by the Stock Exchange rules to publish adequate and up-to-date information. We should add that the information contained in a statement in lieu of

prospectus so far as not provided in other ways is generally out of date by the time the securities to which it relates reach the hands of the public.

248. In these circumstances we are of opinion that the statement in lieu of prospectus can no longer be regarded as serving any useful purpose.

#### *Certificates of exemption*

249. Under section 39 a prescribed stock exchange may exempt an issue of securities for which a quotation on that stock exchange has been sought, from the requirements of section 38 and the Fourth Schedule if, having regard to the size and other circumstances of the proposed issue and any limitation on the number and class of persons to whom that offer is to be made, compliance with the requirements of the Fourth Schedule would be unduly burdensome. We have been told that this provision has proved extremely useful and it has been suggested that it should be extended by giving the same power of exemption to the Board of Trade in relation to securities for which a quotation on a prescribed stock exchange is not being sought. It has been suggested further that there should be a power to give partial, as well as total, exemption from the provisions of the Fourth Schedule, and that exemption might also be given where compliance in full with the provisions of the Fourth Schedule would be irrelevant. We agree with all these suggestions.

250. At paragraph 252 (n-p) below we make a number of detailed recommendations which are designed to remove some minor anomalies in the law relating to prospectuses and allotments.

#### *Registration of prospectuses*

251. Under section 41, no prospectus may be issued unless a copy of it is delivered to the Registrar of Companies for registration. We have recommended elsewhere that the Registrar

should be expressly given a general power to refuse to accept for registration any documents which do not comply with the formal requirements of the Act. We also think it would be useful if the Registrar were empowered (subject to appeal to the Court) to refuse to accept for registration any prospectus offering shares or debentures, for which a quotation on a prescribed stock exchange is not being sought, if it either does not set out the information required by the Act or does so in a manner likely to create a false impression on the mind of an unwary or inexperienced investor. We do not expect the Registrar to do more than reject prospectuses which, on the face of them, appear to him to be cast in a misleading form. He would not be expected to check the accuracy of the contents.

252. We recommend that:

(a) a document which offers securities for a consideration other than cash, but is in all other respects a prospectus as defined in the Act, should be treated as a prospectus; but offers of securities duly complying with the take-over rules should be deemed to comply with the prospectus provisions;

(b) applications made in pursuance of a prospectus issued generally should be irrevocable and remain so until the expiry of seven working days after the date on which the prospectus is first so issued;

(c) no allotment of securities offered to the public should be permitted after the expiry of three months from the date on which the prospectus is first issued;

(d) section 50 (7) of the Companies Act should be repealed;

(e) the Fourth Schedule should be amended so that it requires information (on the lines of that required by the London Stock Exchange) about the following matters:

(i) the authorised, issued and paid up capital;

(ii) loan capital, overdrafts and the directors' borrowing powers;

(iii) the nature of the company's business;

(iv) the company's subsidiaries and holding companies;

(f) the financial information required by the Fourth Schedule should include turnover in respect of the five financial years immediately preceding the issue of the prospectus and the method of computation should be required to be disclosed. There should be a narrowly drawn exemption for companies such as banks and discount companies in respect of which the information would not be useful, and a transitional provision for cases where the information is not available;

(g) the Fourth Schedule should be amended so as to require prospectuses relating to debentures to contain information about such matters as interest, terms of redemption and the security offered;

(h) the Board of Trade should be empowered to amend by statutory instrument the Fourth Schedule to the Act;

(i) the Board of Trade should be empowered to regulate advertisements offering securities made by wireless, television or cinematograph;

(j) the provisions of the Companies Act relating to statements in lieu of prospectus (including those now required under section 30 of the Companies Act to be filed by private companies which through ceasing to be such lose the exemption afforded to private companies by section 48 (3)) should be repealed;

(k) where a certificate of exemption is granted under section 39, any form of application issued in connexion with the offer should be required to be accompanied by a document containing the particulars required to be published as a condition of the granting of a certificate of exemption;

(l) section 39 should provide in express terms that exemption may be granted from compliance with all or any of the requirements of the Fourth Schedule; the section should be extended to enable a certificate of exemption to be granted where full compliance with the provisions of the Fourth Schedule would be irrelevant;

(m) the Board of Trade should be empowered to issue certificates of exemption under section 39, in relation to securities for which no application to a prescribed stock exchange for a quotation has been made, in the same circumstances as such a certificate may be granted by a prescribed stock exchange;

(n) references (now obsolete) in the Act to shares or debentures which are dealt in, as distinct from those which are quoted, on a stock exchange should be omitted;

(o) section 45 (3) (h) should be amended to provide that a copy only of a contract of allotment need be made available for inspection;

(p) a penalty should be provided for any contravention of section 38 (1) in addition to the civil liability imposed by the section;

(q) the Registrar of Companies should be empowered (subject to appeal to the Court) to refuse to accept for registration n prospectus for "unquoted" securities if it does not set out the Information required by the Act or if it does so in a manner likely to create a false impression; and the issue of a prospectus which has not been accepted for registration should be made an offence.

### Dealing in Securities

253. The Prevention of Fraud (Investments) Act makes it illegal for anyone not within one of the following categories to carry on the business of dealing in securities:

(i) members of the London Stock Exchange;

(ii) members of stock exchanges which are recognised by the Board of Trade;

(iii) members of associations of dealers in securities recognised by the Board of Trade;

(iv) the Bank of England;

(v) statutory and municipal corporations;

(vi) dealers exempted by the Board of Trade;

(vii) dealers licensed by the Board of Trade;

(viii) industrial and provident societies and building societies;

(ix) managers and trustees of authorised unit trust schemes.

We have received no evidence to suggest to us that any changes are necessary in the law relating to (i), (iv), (v); we deal with unit trusts in Chapter IX of our Report; and industrial and provident societies and building societies were expressly excluded from our terms of reference. Our comments in paragraph 256 *et seq.* are accordingly confined to the remaining categories,

254. Section 13 of the Act makes it an offence for any person, including an authorised dealer in one of the categories listed above, to induce others *inter alia* to acquire or dispose of securities "by any statement, promise or forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts or by the reckless making of any statement, promise or forecast which is misleading, false or deceptive ". The penalty is a term of imprisonment not exceeding seven years. We are told that there is doubt about the meaning of the word "reckless" in this context, in particular whether a statement must necessarily be dishonestly made in order to be recklessly made. We think that a person should not be liable to imprisonment under this section for

conduct not amounting to dishonesty. But we would resolve a doubt by giving persons, who suffer damage as a result of an untrue statement, promise or forecast in a circular to which section 13 applies, a civil remedy against those responsible unless the latter can prove that they had reasonable cause to believe and did believe that the statement was true or the promise or forecast justified (of. section 43 of the Companies Act).

255. Section 14 forbids any person other than an authorised dealer to distribute circulars containing *inter alia* an invitation to invest or any information calculated to lead directly or indirectly to investment. There is a general exception for circulars for which the Board of Trade gives permission. We deal in paragraph 263 with circulars by investment advisers and in paragraph 268 *et seq.* which the special problem of circulars concerning take-over offers. We have not considered the law relating to circulars soliciting deposits from the public because we were told when our Committee was formed that the Government were proceeding independently to introduce legislation to deal with this important matter. It has been suggested to us, and we agree, that section 14 should be amended so that it - (i) it expressly treats the insertion of an advertisement in a newspaper as equivalent to the issue of a circular;

(ii) the exemption provided by section 14 (4), from the prohibition of these circulars, in favour of a "newspaper, journal, magazine or other periodical publication" distributed to a purchaser should be more narrowly drawn if possible so as to prevent persons distributing investment circulars in the guise of periodical publications.

#### *Stock exchanges and recognised associations of dealers*

256. In addition to the London Stock Exchange, which is recognised in the Prevention of Fraud (Investments) Act itself, twenty stock exchanges are at present recognised by the Board of Trade under that Act. Nine of these, in addition to London, are prescribed by the Board of Trade under section 38 (5) (b) of the Companies Act (relaxation of prospectus provisions in respect of an issue of shares uniform with

shares dealt in or quoted on a prescribed stock exchange); five, in addition to London, are prescribed by the Board of Trade under section 39 (power to grant certificates of exemption). The membership of the fifteen stock exchanges which are not prescribed for the purposes of section 39 is very small, ranging from one to seventeen firms, and from one to thirty-nine individual members. We understand that the six stock exchanges prescribed for the purposes of section 39 have established funds which are available to meet defalcations by their members. So far as we are aware the other recognised stock exchanges have no such compensation funds. We have received no evidence that the operations of these small stock exchanges have led to serious trouble or difficulties. But it seems to us improbable that they can perform, as adequately as the large exchanges, the two important functions of disciplining their members and scrutinising applications for quotations.

257. It seems to us - and the representatives of the Council of Associated Stock Exchanges who gave evidence to us agreed - that the time has come for some rationalisation of the existing exchanges, perhaps by the amalgamation of some of the smaller ones. We also think that investors dealing with members of a recognised stock exchange should be protected by a

compensation fund or by insurance if this is a practical alternative. We recommend, therefore, that the Board of Trade should re-examine the existing list of recognised stock exchanges with a view to reducing their number and increasing their size; and that the Board should satisfy themselves, as a condition of recognition, that stock exchanges have, or will have within a reasonable period, suitable arrangements for the compensation of investors who suffer loss as a result of default by members. Not all the recognised associations of dealers in securities deal directly with individual private investors but, where appropriate, we think that the same requirement should apply to recognised associations of dealers in securities.

#### *Exempted dealers*

258. The conditions for exemption prescribed in section 16 are broadly that:

(i) the main business of the dealer should either be something other than dealing in securities or if it is dealing in securities then it should be wholesale dealing and not dealing with individual members of the public; and

(ii) the greater part of any business of dealing in securities, other than wholesale dealing, should be done through a member of a recognised stock exchange or other authorised channel.

The rather elaborate and complicated terms of this exemption were drafted to deal with the point raised in the following section of the Report by the Bodkin Committee (upon whose recommendations this part of the Prevention of Fraud (Investments) Act was based):

"Concerns such as banks, merchant bankers, discount houses, issuing and finance houses, with whose business it is at once unnecessary and undesirable to interfere, carry out

transactions in stocks and shares which do not lend themselves to such frauds as are within our terms of reference... We found ourselves constantly confronted by the difficulty that measures, intended to control those kinds of share dealings which lend themselves to fraud, would inevitably bring within their ambit some or all of the concerns mentioned above and cause serious interference with their legitimate and useful activities."

We have received no evidence that his exemption of banks and other financial houses has led to abuse - indeed we have been told that the status of exempted dealer is prized beyond its practical worth as an indication of the high reputation of the holder - and we think that the present arrangements under which exemption is conferred should broadly continue as at present. We do not agree with the suggestion which has been made that exempted dealers should in future be made subject to the Rule for Licensed Dealers relating generally to circulars (though we recommend in paragraph 294 (a) that the Rules for Licensed Dealers relating to take-over circulars should apply to exempted and other authorised dealers.

259. The Board of Trade are not expressly required by the Act to have regard to the reputation and business reliability of applicants for exemption, although the Board have informed us that they do take these factors into account, and section 16 (3) (b) appears to envisage that they are to be taken into account by the Board in deciding whether to

withdraw an exemption. Moreover, the Board are not empowered to make enquiries to ensure that an exempted dealer continues to merit exemption. We think that the Act should require the Board of Trade to be satisfied about the reputation and business reliability of those granted exemption and that the Act should expressly empower the Board to make reasonable enquiries to ensure that exempted dealers continue to fulfil the conditions of exemption.

260. When the provisions which are now contained in section 16 of the Prevention of Fraud (Investments) Act first came into force in 1944, there were a number of financial institutions which were already dealing in securities and which could show that they carried on the kind of business for which the Act provided exemption. Since the Act came into force no new company can establish a pattern of business, including dealing in securities, of a kind which would justify the Board of Trade granting it exemption unless it had first become a licensed dealer. We suggest below that, in the main, the category of licensed dealer should be restricted in future as far as possible to those whose principal business is dealing in shares with members of the public, and if this recommendation were accepted it would become even more difficult than it already is for new companies to establish themselves in 'the sort of business carried on by an exempted dealer. We suggest, therefore, that the Board of Trade should be empowered to grant provisional exemption to persons who, in the opinion of the Board, are likely to fulfil the conditions of exemption within a period of, say, two years. At the end of that period the Board should have power either to extend the provisional exemption for a further period or to withdraw it, or to confer complete exemption.

#### *Licensed dealers*

261. We have been told that the system of licensing dealers was introduced to provide for the small external broker who is not a member of a recognised association of stock and share dealers. We understand that at present only thirty-five persons are licensed dealers and few of these come within the category for which the system was originally introduced. The majority comprise companies engaged in issuing and other financial business who are not exempted dealers. The licensed dealer, unlike other authorised dealers in securities, is

required to deposit £500 as a condition of this licence and to comply with statutory rules made by the Board of Trade. The licences are renewable annually. The latest version of the rules (the Licensed Dealers (Conduct of Business) Rules, 1960), provides for the keeping of proper books of account and records; requires the dealer when making written offers about securities of companies to provide specified information; and lays down those requirements for the conduct of take-over offers and the contents of take-over circulars which we suggest in paragraph 294 below should be generally applicable to all take-over offers and circulars irrespective of the channel through which they go.

262. We think it might have been better if from the start licences had been issued only to those for whom they were originally intended. If issuing houses and other financial companies do not attain the standards required for exemption we doubt whether it is wise to enable them to

carry on such a business under a licence from the Board of Trade. But we think it would be unreasonable now to refuse to renew a licence held by such persons solely on the ground that it was no longer considered appropriate that such persons should be licensed. Where, however, licences have been issued to those who do not require them, and have not used them, to carry on their ordinary business (for example, we understand that some licensed dealers have used their licences only to issue take-over circulars), we think the Board might reasonably refuse to renew such licences. We suggest, therefore, that the Board should, in the main, restrict the issue of new licences to persons carrying on the business of dealing in securities directly with members of the public though we recognise that there may be exceptional circumstances which justify the issue of a licence to other dealers. We think that the Board should refuse to renew licences of those who are not so dealing, in cases in which the withdrawal of the licence would not prevent the persons concerned from carrying on their ordinary business.

#### *Investment advisers*

263. A person who is not an authorised dealer in securities (see paragraph 253), but who distributes circulars advising his clients about their investments, would appear to be in breach of section 14, although if a charge is made for the circulars it is arguable that they are periodical publications issued to purchasers and therefore outside the scope of that section. An investment advisory business, which is conducted on the basis of a charge related to results, is a business of dealing in securities within the definition of section 26. Many investment consultants and advisers are already authorised dealers in securities, usually by virtue of their other activities, but there is no provision in the Act for the conduct, as a separate, specialised activity, of the business of investment adviser. We think that the new Act should make such provision, so that a bona fide investment consultant may issue circulars to his clients without risk of being in breach of section 14. We suggest, therefore, that the Act should empower the Board of Trade to license investment advisers on the same sort of terms and conditions as now apply to licensed dealers in securities, and that such licensed advisers should be included in the categories which are exempted by section 14 (3) (a) from the provisions of that section.

264. We recommend that:

(a) the Prevention of Fraud (Investments) Act should provide persons, who suffer damage as a result of an untrue statement, promise or forecast in a circular to which section 13 applies, with a civil remedy against those responsible unless they can prove that they had reasonable cause to believe and did believe that the statement was true or the promise or forecast justified;

(b) section 14 should be extended expressly to include newspaper advertisements containing invitations to Invest and information calculated to lead to investment;

(c) the exemption in section 14 (4), in favour of a "newspaper, journal, magazine or other periodical publication" distributed to a purchaser, should if possible be drawn more narrowly

(d) the Board of Trade should re-examine the list of recognised stock exchanges with a view to reducing their number and increasing their size;

(e) the Board should satisfy themselves, as a condition of continuing recognition, that stock exchanges and, where appropriate, associations of stock and share dealers have made, or will make within a reasonable period, suitable provision for meeting losses by the public arising from default on the part of members;

(f) the Board should be required to be satisfied as to the reputation and business reliability of those granted exemption under section 16;

(g) the Board should be empowered to make reasonable enquiries to ensure that exempted dealers continue to fulfil the conditions of exemption;

(h) the Board should be empowered to grant provisional exemption to those who, in the opinion of the Board, are likely to fulfil the conditions of exemption within a period of, say, two years;

(i) the Board should restrict the issue of new licenses to deal in securities, in the main, to persons tarrying on the business of dealing in securities directly with members of the public;

(j) the Board should refuse to renew the licenses of those who are not dealing in securities directly with members of the public except where this refusal would prevent those concerned from tarrying on their ordinary business;

(k) the Board should be empowered to license Investment advisers on the same sort of terms and conditions as are applied to licensed dealers; such licensed advisers should be

included in the categories of persons exempted by section 14 (3) (a) from the provisions of that section and thus authorised to issue circulars to their clients.

## **Take-over Bids**

### *General*

265. There appears to be general agreement that take-overs, mergers and amalgamations of companies which in one guise or another have been taking place for very many years, are an essential feature of economic growth and development. The take-over bid has been found in practice to be a convenient method of amalgamation, and like other convenient arrangements it has on occasion been abused. In the paragraphs which follow (and elsewhere in our Report, particularly in the section dealing with the provision of financial assistance by a company for the purchase of its own shares) we make suggestions which are intended to limit the risk of abuse within the field covered by our terms of reference. As already stated, we have not embarked on an examination of the broader economic and social questions which have been raised in relation to some recent bids as these are beyond our terms of reference. But it should be remembered that such questions as the concentration of economic power have been raised in relation to a very small proportion of the hundreds of company amalgamations of one kind and another which take place each

year. In framing our suggestions we have tried to avoid, as far as possible, placing obstacles in the way of honest and fairly conducted take-over transactions.

266. In this connexion we would refer to the suggestion, which had been made to your predecessor and referred by him to us, that in every take-over offer at least some part of the consideration offered should be required to be in cash. We presume that the dominant motive behind this suggestion was that it would curb take-over bids by companies which might be in a position to issue large quantities of their own shares but could not find the necessary cash. There have no doubt been many cases of amalgamations or take-overs where the bidding company has not had cash available, and where if there had been such a statutory requirement the amalgamation or take-over would not have come about. But we have had no evidence to suggest that such amalgamations or take-overs have on that account been undesirable or disadvantageous to the shareholders of either company and we see no justification for imposing upon all offers to acquire companies or controlling interests therein a requirement that part of the consideration should (or should at the option of the offeree) be in cash. Very many mergers or take-overs have gone through on the basis, acceptable to all parties, that the transaction should be on a share exchange basis, so that a certain proportion of the equity of the bidding company or new holding company should be available for the shareholders of the company being acquired. We make some recommendations in paragraph 294 below, which should ensure that adequate information is disclosed in a take-over or merger offer to the shareholders. In the light of such disclosure we think that the shareholders should be allowed to judge for themselves whether or not to accept the offer. A requirement that all such offers should be partly in cash would present a number of complications and make many mergers or take-overs impossible or more difficult (and expensive if relief from transfer duty and capital duty under section 55 of the Finance Act 1927 which might otherwise be available were thereby lost) and would not necessarily be for the benefit of any of the shareholders or companies concerned.

#### *Take-over bids and employees*

267. While we are very much aware that the livelihood of employees and directors may be affected by a take-over bid,

the problems of redundancy and contractual rights which may arise following a take-over are clearly matters which may arise in many other circumstances, and cannot appropriately be dealt with by amendments of company law. Some of our witnesses, including the Trades Union Congress, have, however, suggested that it would be useful if any person making a take-over bid were required by statute, when making the bid, to disclose his intentions as regards the future of the company and the employees. We have noted that in the "Notes on Amalgamations of British Businesses" produced by a group of city institutions in 1959 a recommendation to this effect is made and we agree that it is desirable that an offeror should state his intentions as far as he is able. We think, however, that a statutory requirement on this matter would frequently be ineffective in securing useful information. In many cases the offeror would not be able to decide, until he had actually

achieved control, what degree of rationalisation with another business was possible and the extent of any resultant redundancy. Moreover, since it would be impossible to enforce implementation of the stated intentions, a statutory requirement might encourage the making of inaccurate or misleading forecasts.

### *The present system of control*

268. Section 14 of the Prevention of Fraud (Investments) Act, 1958, restricts the channels through which circulars containing offers to sell or purchase securities (not being prospectuses within the meaning of the Companies Act) may be distributed. The section thus controls, *inter alia*, the distribution of take-over circulars. We discuss generally in paragraphs 253-262 the categories of persons who are permitted to deal in securities and are thus authorised to distribute such circulars. Those of practical significance are (i) members of recognised stock exchanges, (ii) exempted dealers in securities, (iii) recognised associations of dealers, (iv) licensed dealers. Circulars containing take-over and other offers may only be circulated by other persons with permission from the Board of Trade. Finally, circulars relating to a scheme of arrangement under section 206 are scrutinised by the Court.

269. Under powers conferred by section 7 of the Prevention of Fraud (investments) Act the Board of Trade has made the Licensed Dealers (Conduct of Business) Rules, 1960. These Rules impose requirements applicable to all offers (including take-over offers) to purchase or sell securities made by or through a licensed dealer (First Schedule, Part I and Second Schedule to the Rules), and additional requirements relating to take-over offers and to the contents of circulars containing, or relating to, such offers (First Schedule, Part II and Third Schedule). A take-over offer is defined in the Rules as "an offer to acquire securities of a corporation made to more than one holder of those securities calculated to result in any person acquiring, or becoming entitled to acquire, control of that corporation...". In respect of take-over offers the Rules lay down certain basic procedural requirements and also require disclosure of a certain minimum of information in any circular making such an offer or making a recommendation by the directors of the offeree company to

accept such an offer. Although the Rules statutorily apply to licensed dealers only, the recognised stock exchanges and other authorised dealers in securities also broadly comply with them when issuing circulars containing a take-over offer or a recommendation by the directors of an offeree company to accept such an offer. The Board also insists that any take-over circular which is to be issued by persons other than authorised distributors and which therefore requires the Board's approval, shall comply with these Rules. Thus the Board of Trade's Rules for Licensed Dealers, in so far as they relate to take-over offers, are in fact generally observed.

#### *Proposed new system of control*

270. The present legal system for controlling takeover offers is thus quite different from that which governs the issue of prospectuses. The main features of the latter are that anyone may issue a prospectus so long

as he complies with the Companies Act, which sets out in considerable detail the information to be given and imposes heavy liabilities, civil and criminal, on persons responsible for issuing prospectuses containing fraudulent or reckless statements; exemption from providing the information prescribed by the Act may, in appropriate cases, be granted by a prescribed stock exchange to whom an application for a quotation for the securities offered has been made. If the proposals we make at paragraph 252 (m) are accepted, the Board of Trade will enjoy a similar power of granting exemption where a quotation on a prescribed stock exchange has not been sought in respect of the securities in question and the Registrar of Companies will be empowered to refuse to accept for registration (subject to appeal to the Court) any prospectus offering such securities, if it either does not set out the information required by the Act or does so in a manner likely to create a false impression. We think that the making of take-over offers should be regulated broadly in the same way: that is to say, anyone should be free to make a take-over offer so long as it complies with the law; rules governing the procedure to be followed and the information to be given in a take-over circular should apply to all take-over offers irrespectively of the status of the person by or through whom they are made; there should be similar rules applicable to circulars from directors of the offeree corporation to their shareholders; there should be a civil remedy as well as a criminal penalty for fraudulent or reckless statements in take-over circulars (as we have already recommended in paragraph 264 (a) above); the Board of Trade should be empowered to exempt any particular take-over offer from complying with the full requirements of the rules where such compliance appears to be inappropriate; all circulars containing take-over offers or recommending acceptance of such offers should be required to be filed with the Registrar of Companies, who should be given power to refuse to accept for registration (subject to appeal to the Court) any circular which does not set out the information required by the rules or does so in a manner likely to create a false impression. The requirements of section 14 of the Prevention of Fraud (Investments) Act should thus cease to apply to take-over offers, for which, as the Board of Trade have pointed out to us, they were not originally designed, but other circulars would continue to be subject to the scheme of distribution through authorised channels now imposed by section 14 of the Prevention of Fraud (Investments) Act. For these other circulars, it has not proved possible to formulate a comprehensive body of statutory rules (nor would it be reasonable to expect the Registrar of Companies to check the adequacy and fairness of their contents) and therefore the

main safeguard for the investor must continue to be control of the channels through which they are disseminated.

271. These proposals seem to us to have the following advantages: - In the first place two very similar subjects will be treated in broadly the same way, which will make for simplicity and eliminate anomalies: secondly, it will no longer be legally necessary for a person who wishes to make a take-over offer otherwise than through an authorised channel to seek the permission of the Board of Trade. We appreciate that our proposals involve a radical change in the legal basis of the present system of control, but we

do not think that it will involve a radical change in the practical conduct of take-over offers, since, as we have already pointed out, such offers are to a great extent already conducted in accordance with the rules applicable to Licensed dealers. We consider below in detail the new system for regulating take-over offers.

### *Powers of Board of Trade*

272. We think that the Board of Trade should in future have power to make rules, by statutory instrument, applicable to every take-over offer and to every circular containing a take-over offer, or a recommendation to the members of the offeree company by their directors to accept such an offer. Cases may occasionally arise where it would be inappropriate for a take-over circular to furnish all the information required by the general rules. We suggest therefore that the Board of Trade should be given a power of exemption; the power should be exercisable only in special cases and we hope that the Board would exercise it very sparingly. These rules of general application would follow in the main the Rules for Licensed Dealers as they relate to take-over offers, but we recommend below some changes and extensions, and we hope that the Board of Trade will from time to time reconsider these rules, with the Consultative Committee to which we have referred earlier in this Chapter, to ensure that they are kept up to date.

### *Circulars recommending rejection*

273. We do not think it would be practicable to devise rules, which would be applicable in all cases, governing the contents of circulars by directors or members of the offeree company recommending rejection of an offer. We do not recommend that such circulars should be required to be filed with the Registrar of Companies nor do we think that it should be necessary for such circulars to be distributed through authorised channels or with the prior consent of the Board of Trade. We think it would be sufficient if such circulars were subject to a provision on the lines of section 13 (as amended in the light of our recommendations), which would provide penalties for issuing circulars containing fraudulent or reckless statements.

## *Procedure*

274. The Licensed Dealers (Conduct of Business) Rules, 1960 lay down the following principal requirements for take-over offers:

(i) The terms of the offer shall be delivered to the offeree company not less than three clear days, excluding holidays, before the offer is despatched to the offerees.

(ii) A take-over offer shall, unless totally withdrawn, remain open for acceptance for at least twenty-one days.

(iii) Where the offer is conditional a date shall be specified as the latest date on which the offeror can declare the offer unconditional.

(iv) The acquisition of securities to which the offer relates shall not be conditional upon the offerees approving any payment or other benefit to any director of the offeree company.

(v) If the offer relates to less than the total amount in issue of any class of securities the offer shall be open to acceptance by all

holders and it tot, many acceptances are received they shall be sealed down pro rata.

(vi) Information on a number of specified matters, outlined in paragraph 280 below, shall be given in the circular containing the offer.

Most witnesses have expressed the view, and we agree, that these Rules provide a most effective and useful guide to the proper conduct of take-over offers. There are, however, several points to be considered.

275. First, it has been suggested, and we agree, that a copy of every circular which contains, or recommends acceptance of, a take-over offer should be sent, together with copies of any documents referred to therein, to the Registrar of Companies and that he should be required to place any circular which he accepts for registration, and the accompanying documents, on the file of the offeree company immediately after circulation to the offerees. The Registrar should be empowered to refuse to accept for registration (subject to appeal to the Court) any such circular which does not give the information required by the Rules or which does so in a manner likely to create a false impression, and the issue of a circular which has not been accepted for registration should be an offence.

276. Secondly, it is common practice for the offeror to require unconditional acceptance by the acceptor although the offeror is not bound unless acceptances in respect of the required number of shares are received. Some witnesses have objected strongly on principle to a contract which is made unconditional for one party but conditional for the other, and it has been pointed out that in practice this arrangement can lead to inequity. For example, a take-over offer may be made by A and immediately accepted by some of the offeree. B then makes an offer at a higher price. Thereupon A, having declared his original offer unconditional, transfers to B the shares which he has acquired at the lower price and pockets the difference. On the other hand, it has been cogently argued before us that chaos would follow if acceptors were free to withdraw their acceptances at any time, and that a take-over bidder, who fails to secure sufficient acceptances for

control, ought to be allowed to withdraw his offer. As to the example cited above, it is said that the offerees are in a position to defend themselves by deferring acceptance of an offer until the period for which the offer is open is on the point of expiring. We support the view that the present practice of making conditional offers and requiring unconditional acceptances should not be prohibited by law. We have considered various other suggestions designed to protect offerees from the sort of practice of which we have given an example above, but we do not think that a case has been made out for any general statutory protection of offerees in this respect. We would, however, agree that if any offeror varies the terms of his offer by increasing the price an acceptor of the initial offer should be entitled to receive the higher price and that acceptance of the initial offer should be deemed to be acceptance of the first offer for the purposes of section 209. This is common practice in most take-over offers at the present time, and a statutory provision to this effect should not create practical difficulties for offerors, though we recognise that evasion might be easy to achieve and hard to detect.

277. Thirdly, we agree with the present requirement in the Board of Trade Rules that a take-over offer should, unless totally withdrawn, be open for acceptance for at least twenty-one days. Offerees will then have full opportunity to consider the offer and if it is inadequate there will be an opportunity for others to improve upon it. But we think also that a limit should be set to the period during which the offeror may keep his offer conditional, otherwise acceptors may be bound, without knowing whether or not their acceptances will be taken, for an unreasonable period. We suggest, therefore, that if the offeror has not declared his offer unconditional within, say, thirty-five days from the date on which it was sent to the offerees, any acceptor should be free thereafter, notwithstanding the terms of his acceptance, to revoke it.

278. Fourthly, we agree with the suggestion made by several witnesses that when a take-over offer is declared unconditional the offeror should be required to disclose the number and proportion of shares of each class which he then has or controls (as a result of the offer or otherwise). This will enable non-accepting shareholders to re-assess their position in the company and to make an informed decision whether to accept any extended offer which may be made to them.

279. Finally, it has been suggested and we agree, that it should be made clear that directors of an offeree company are entitled to reimbursement from the funds of the offeree company of expenses properly incurred by them on behalf of, and in the interests of, the members of the offeree company in connexion with a take-over offer.

#### *Information to be given in take-over circulars*

280. We have expressed above the opinion that anyone who makes a take-over offer should be required to comply with general rules on the lines of those now applicable to take-over offers made by licensed dealers. The current Rules prescribe in considerable detail the information to be included in a take-over circular issued by a licensed dealer but their main purport may be summarised as follows - the bidder must be identified, the offeree must be given specified information

bearing upon the value of the securities he is being invited to transfer and. where the bid takes the form of an offer of securities for securities, the value of the securities he is being invited to accept in return for his own securities; other facts likely to affect the offeree's decision must also be given, such as the extent of the offeror's interest in the securities of the offeree company and details of any special treatment to be accorded to the directors of the offeree company; where a circular contains a recommendation by the directors of an offeree company that an offer be accepted, further details must also be disclosed.

281. There is general agreement that an offeree should be entitled in all cases to the information which a licensed dealer is now required to give when he is making a take-over offer and most of the detailed recommendations made to us about the contents of take-over circulars will be met if our proposals for applying the current Rules to all take-over offers are accepted. We think, however, that in some respects the existing Rules should be made stricter. (We have already indicated that we think the

Board of Trade should have power to give exemption in special cases.) Paragraph 2 (5) of Part II of the First Schedule to the Rules provides that, if a licensed dealer makes a take-over offer on behalf of some other person, the circular must state whether or not the licensed dealer has taken any steps to ascertain that that person will be in a position to implement the offer if it is fully accepted by all the offerees, and if so, what steps. In our view this does not go far enough. We would not go so far as those witnesses who have suggested that, where a cash offer is made, the offeror should be required to provide security for the payment of the maximum possible cash consideration. On the other hand, we do think that such a take-over circular should contain a definite statement, in the form of a representation binding the offeror, saying what steps he has taken to ensure that the necessary cash will be available. Generally speaking, the current Rules require adequate disclosure of any special terms offered the directors of an offeree company: we have already recommended, however, that sections 191, 192 and 193 (which relate to the disclosure and approval necessary for the payment to directors of compensation for loss of office, etc.) should require disclosure of the total payments which it is proposed to make; it follows that similar disclosure should be required in take-over circulars.

282. Section 40 of the Companies Act contains provisions designed to ensure that a statement purporting to be made by an expert shall not be quoted in a prospectus without the consent of the expert concerned. In our view, it is equally important that there should be similar safeguards against the unauthorised quotation of expert statements in circulars containing take-over offers. We think it particularly important that figures should not be described as "audited" unless the auditor concerned has given his consent to the use of those figures in the context in which they appear, but in our view the rule should be made to apply to all statements quoted in take-over circulars and alleged to be made by experts.

*Minority shareholders - compulsory acquisitions right to be bought out*

283. Under section 209 (1), where a small minority of shareholders have not accepted a take-over offer, they are liable to have their shares compulsorily acquired by the

offeror and under section 209 (2) they have a corresponding right to call upon the offeror to buy them out. This power and this right may be exercised only if the offeror is a company "whether a company within the meaning of this Act or not". It has been suggested that both the power to acquire and the right to be bought out should be available even if the offeror is an individual. We do not think it reasonable to give to an individual a power of compulsory acquisition which is designed to facilitate the merger of companies, nor do we think that a dissentient minority should be given rights trader section 209 against an individual offeror since the latter could never have powers of compulsory acquisition. We also think that the section was never intended to apply, and should not apply, unless the offer was made for all the outstanding shares of the company (or all the outstanding shares of a class) and on the same terms to all the shareholders concerned. This is not made as clear as it might be and we think the section should be amended to make it clear.

284. There appears to be doubt whether the power of compulsory acquisition and the right to be bought out provided in section 209 arise in respect of any class of share unless the prescribed conditions have been separately fulfilled in relation to that class. In our view an offer expressed as a single offer for shares off more than one class should be treated as comprising as many offers as there are classes of shares involved. We think that section 209 should be amended to make this clear.

285. The right to be bought out conferred by section 209 (2) may be exercised only if the result of the offer is that the offeror company holds, or can call for the transfer of, 90 per cent. of the shares concerned. It has been suggested that if the result of a bid is to give the offeror company a bare majority of those shares, the non-assenting minority should be given the right to call upon the offeror to buy them out. In our view, this proposal, which would have the effect of converting every partial take-over offer into an offer for all the outstanding shares of the class concerned, goes too far. On the other hand, we think that if the offer is made for the whole or such lesser percentage as the offeror company may accept and if the offeror declares the offer unconditional then any offerees who have not accepted the offer should have, say, fourteen days from the date when the offer has been declared unconditional to require the offeror to take their shares at the offer price.

286. Time limits are imposed upon the exercise both of the power conferred by section 209 (1) and the corresponding right conferred by section 209 (2). Notice of compulsory acquisition under section 209 (1) may be given only if there has been a 90 per cent. approval within four months after the making of the offer and such notice may be given only during the period of two months after the end of the four months already mentioned. Under section 209 (2) the offeror must inform the minority shareholders of their right to be bought out within one month after the date of the transfer by virtue of which their right arose and the minority holder may give notice requiring the offeror to buy him out within three months of the giving of the offeror's notice. We suggest that in future an offeror who has received the requisite 90 per cent. approval should be empowered to issue a compulsory acquisition notice at any time not later than four months after the date of the offer. We think that a dissentient shareholder, who has been served with

a compulsory acquisition notice, should be given two months instead of one in which to apply to the Court for an order that he is not bound to transfer his shares on the terms offered. One advantage of this change will be that the offeror will no longer necessarily be required to give notice under section 209 (2) (a) to the dissentient shareholders of his acquisition of 90 per cent. or more and subsequently to give separate notice under section 209 (1) to these shareholders of his intention to acquire their shares compulsorily.

287. Under section 209 (1) the Court may only order that the shares of a dissentient shareholder shall or shall not be compulsorily acquired, whereas under section 209 (2) the Court is empowered to vary the terms on which a dissentient shareholder is to be bought out. We see no good reason for this difference, and we suggest that section 209 (1) should be amended to empower the Court to vary the terms on which the shares of the dissentient shareholder are to be compulsorily acquired.

288. An offeror who has a substantial holding in the shares concerned when he makes his offer cannot exercise the power of compulsory acquisition conferred by section 209 (1) merely by virtue of his obtaining 90 per cent. of the shares in other hands. Under the proviso he must also (a) offer the same terms to all the shareholders and (b) obtain the approval of at least three-fourths in number of the holders of those shares. We have already recommended that section 209 should apply only to offers which comply with condition (a) and we see no justification for the additional condition (b) and we think the proviso to section 209 (1) should be repealed.

289. Offers frequently provide two or more alternative sets of terms between which the acceptor may elect. Unless, in such a case, the offer is carefully framed, the offeror company may find itself unable to operate the section if dissenting shareholders refuse to express an election. We think that the offeror company should be enabled to stipulate, in giving the notice required by section 209 (1), which of the alternative sets of terms is to apply in the absence of an election by the dissentient within a period prescribed in the Act.

290. The notice required by section 209 (2) (a) must be given within one month of the "transfer" of the requisite shares. This has been criticised on the ground that the material date for this purpose should be the date when the beneficial ownership in the requisite number of shares has been acquired. Section 209 (2) has also been criticised on the grounds that it seems to require the notice to be given not only to those share-holders who have still not accepted the offer by the time the notice is given but to those who accept the offer between the date of the "transfer" and the date the notice is given, which is clearly unnecessary. Finally, it has been suggested that the period of three months, prescribed in section 200 (2) (b), should be reduced to two months. We agree with these criticisms and recommend that section 209 (2) should be amended accordingly.

291. It has been represented to us that the provisions of section 209 are open to evasion and we were told, for example, that it was possible for an offer to be made in such circumstances that the offeror could exercise powers of compulsory acquisition although he had not obtained the necessary approval from genuinely independent shareholders. We

were also told that it is possible for an offeror to defeat the rights of an offeree under section 209 (2) by procuring the offer to be made by a subsidiary of a company which already had a substantial holding; the result of such an offer might be to vest in a subsidiary a number of shares which was insufficient to bring the provisions of section 209 (2) into operation but which, when added to the shares already held by the subsidiary's holding company, put the dissentient shareholder in precisely the position from which section 209 (2) was designed to protect him. We appreciate that the decision in the case of *Re Bugle Press Ltd.* [1961] Ch. 270 clearly established that the approval required by section 209 (1) is the approval of shareholders who are genuinely independent of the offeror. We think, however, that section 209 (1) should be amended to provide that it operates only where the offer has been approved by the holders of not less than nine-tenths of the shares whose transfer is

involved other than shares held by, or by a nominee for, the transferee company or any company in the same group as the transferee company. Section 209 (2) should also be amended to require that all shares held by any member of the same group as the offeror shall be taken into account in deciding whether the right to be bought out has arisen.

292. We think that the machinery provided in section 209 (3) and 209 (4) for completing a compulsory acquisition is generally satisfactory, but we agree with the suggestion that it should be expressly provided that an offeree company is not obliged to pay over cash or to deliver any other consideration held by it under section 209 (4) to a dissentient shareholder except upon production of his share certificate or other evidence of title or (if he has lost his certificate) the giving of a satisfactory indemnity by the dissentient shareholder.

293. We have received other suggestions, from the General Council of the Bar and others, for clarifying section 209 and we have passed these to the Board of Trade for consideration when a new Act is being drafted.

294. We recommend that:

(a) the Board of Trade should have power to make rules, by statutory instrument, applicable to every take-over offer and to every circular containing a take-over offer, or a recommendation to the members of the offeree company by their directors to accept such an offer, no matter by whom such circular or offer is distributed or made;

(b) the Board of Trade should be empowered to grant exemption from compliance with the statutory rules;

(c) circulars containing, or recommending acceptance of, take-over offers should no longer be required to be sent through authorised channels or approved by the Board of Trade. But

they should be required to be sent for registration to the Registrar of Companies before circulation; he should be empowered (subject to appeal to the Court) to refuse to register any such circular which does not set out the information required to be given by the statutory Rules or does so in a manner likely to create a false impression. The issue of a circular which has not been accepted for registration should be made an offence; the Registrar should be required to place any circular he has accepted for registration together with the accompanying documents on the file of the offeree company immediately after circulation to the offerees;

(d) circulars by directors or by members of the offeree company recommending rejection of a take-over offer should not be required to be circulated through an authorised dealer nor to be registered nor subject to statutory rules. They should however be subject to a provision on the lines of section 13 of the Prevention of Fraud (Investments) Act (extended as we propose above to provide a civil remedy);

(e) an offeror who, after making a take-over offer, subsequently varies the terms of his offer by increasing the price, should be required to pay the higher price for shares accepted on the initial as well as the amended offer; and acceptance of the initial offer should

be deemed acceptance of the final offer for the purposes of section 209;

(f) if an offer is not declared unconditional within thirty-five days any acceptor should be free thereafter to revoke his acceptance;

(g) when a take-over offer is declared unconditional the offeror should be required to disclose the number and proportion of shares of each class which he then has or controls (as a result of the offer or otherwise);

(h) it should be made clear that directors of an offeree company are entitled to reimbursement from the funds of the offeree company of expenses properly incurred by them on behalf of, and in the interests of, the members of the offeree company as the result of a take-over offer;

(i) every take-over circular, offering cash for securities, should contain a definite statement, binding on the offeror, saying what steps he has taken to ensure that the necessary cash will be available;

(j) every take-over circular should include a statement of all payments proposed to be made to the directors of the offeree company which fall within the ambit of sections 191, 192 and 193 amended in accordance with our recommendations elsewhere;

(k) a statement, purporting to be made by an expert should not be quoted, without the consent of the expert concerned, in any circular containing a take-over offer or recommendation by the directors of the offeree company to accept such an offer;

(l) section 209 should be amended as follows:

(i) to make it clear that it applies only to offers, got all outstanding shares of the company (or all outstanding shares of a class), made on the same terms to all the shareholders concerned;

(ii) to make it clear that an offer expressed as a single offer for shares of more than one class should be treated as comprising as runny offers as there are classes of shares involved;

(iii) to provide that where an offer has been made for the whole or such lesser percentage as the offeror will accept of the shares of any class, and the offeror has declared the offer unconditional, any offerees who have not accepted the offer should have, say, fourteen days from the date when the offer was declared unconditional to require the offeror to take their shares at the offer price;

(iv) to empower an offeror who has received 90 per cent. acceptances to issue a compulsory acquisition notice at any time not later than four months after the date of the offer; a dissentient shareholder should be given a period of two months (instead of one month) from the date on which the compulsory acquisition notice was given to make his application to the Court;

(v) to provide that section 209 (1) operates only where the offer has been approved by the holders of not less than nine-tenths of the shares whose transfer is involved other than shares held by, or by a nominee for, the transferee company or any company in the same group as the transferee company;

(vi) to empower the Court to vary the terms on which the shares of a dissentient shareholder are to be compulsorily acquired under section 209 (1);

(vii) to repeal the proviso to section 209 (1);

(viii) where an offer for shares provides two or more alternative sets of terms, to enable the offeror company to stipulate, in giving the notice required by section 209 (1), which of the alternative sets of terms is to apply in the absence of an election by the dissentient within a period prescribed in the Act;

(ix) to require the notice required by section 209 (2) to be given within one month of acquisition of beneficial ownership of the requisite number of shares; and to require such notice to be given only to those shareholders who have not accepted the offer by the time the notice is given;

(x) to reduce to two months the period of three months prescribed in section 209 (2) (b);

(xi) to require that all shares held by any member of the same group as the offeror shall be taken into account in deciding whether for the purpose of section 209 (2) the right to be bought out has arisen;

(xii) to provide that an offeree company should not be obliged to pay over cash or to deliver any other consideration held by it under section 209 (4) to a dissentient shareholder except upon production of his share certificate or other evidence of title or the giving of a satisfactory indemnity by the dissentient shareholder.

## CHAPTER VIII

### LOAN CAPITAL

#### *Register of debenture holders*

295. If a company keeps a register of debenture holders, it must comply with the provisions of section 86 relating to the place at which the register is kept and the provisions of section 87 relating to inspection and the furnishing of copies, but nowhere does the Act require such a register to be kept. (For the purposes of the Act "debenture" includes debenture stock, bonds and any other securities whether constituting a charge on the assets of the company or not.) The absence of such a provision can prejudice the position of the holders of debentures, forming part of a series ranking *pari passu*, or of debenture stock; in the absence of an up to date record of the names and addresses of the holders it is difficult if not impossible for them to organise action in defence of their common interests. We would impose on the company a duty to keep a register containing the name, and addresses and particulars of the current holdings of every person who is for the time being the holder of debenture stock or of a debenture forming part of a series of debentures issued by the company ranking *pari passu* with the other debentures of that series. Such a requirement could not apply to debentures transferable by delivery. It should apply whether or not the debentures are secured by a charge on the company's assets and whether or not they are covered by a debenture trust deed. The provisions of sections 86 and 87 should continue to apply to the register, but we would amend section 87 by providing that copies of the trust deed or other trust instrument or of the register of holders should be supplied within ten days and 'by making provision for the Board of Trade to fix, by statutory instrument, the maximum charges for supplying such copies (in place of the maximum charge 'at present prescribed in section 87).

296. It has been pointed out to us, and we agree, that subsection (3) of section 87, which gives a holder of debenture stock the right to be furnished with a copy of the debenture trust deed, should be extended to cover cases where

the instrument creating the debenture stock does not take the form of a trust deed.

*Model debenture trust deed*

297. Most large issues of debentures are now issued in the form of debenture stock constituted by a trust deed, the covenant to pay principal and interest being made with, and any charge for securing the issue vested in, trustees for the benefit of the individual debenture stock holders. Some witnesses have pointed out that the contents of such trust deeds have to a great extent become standardised and they have accordingly suggested that

it would be useful if the Act contained a model debenture trust deed, which companies would be free to adopt in the same way as they can adopt Table A as their articles of association. We do not agree with this suggestion; no two cases are ever alike and the provision of a statutory form would only encourage drafting by reference and might lead to error and confusion. On the other hand where provision is made in respect of a series of debentures or debenture stock for meetings of the holders then we suggest that provisions on the lines of sections 132. 135. 136, 137 and 138 (meetings of shareholders), *mutates mutandis*, should apply.

#### *Enforcement of securities - powers and liabilities of receivers*

298. Section 369 (1) provides that a receiver appointed out of Court may apply to the Court for directions in any particular matter arising in connexion with the performance of his functions and empowers the Court on such applications to give such directions, or make such order declaring the rights of persons before the Court or otherwise, as the Court thinks just. We think it would be useful if the Court could exercise the same powers on the application of a debenture holder, as, of course, it can already do if the receiver is appointed by the Court.

299. A receiver appointed out of Court under a charge that subsequently proves to be invalid or in circumstances which do not make the power of appointing a receiver exercisable is a trespasser and may incur heavy liabilities especially if he has purported to act as receiver and manager. We agree with the suggestion that the Act should empower the Court to relieve a person so appointed, wholly or to such extent as it thinks fit, from personal liability in respect of any, thing done or omitted to be done by him which had he been validly appointed, would have been properly done or omitted. The Court should also be empowered to make the person, by whom the invalid appointment was made, personally liable to the extent that the person purported to be appointed receiver has been relieved of liability by the Court.

#### *Registration of charges*

300. The charges required to be registered in the register of charges kept by the Registrar of Companies are set out in sections 95 (2) (applicable to English companies) and 106A (2) (applicable to Scottish companies) of the Act. Sections 106A to 106K inclusive, which were added to the Act by the Companies (Floating Charges) (Scotland) Act, 1961, make applicable to Scottish companies substantially the same provisions as sections 95-106 inclusive make applicable to English companies. For convenience we refer in the ensuing paragraphs only to the English sections but our recommendations are intended to apply also to Scottish companies.

301. Successive Companies Acts have added considerably to the number of charges required to be registered but by no means all the charges a company may create in the course of its business are required to be registered. It has been proposed that all charges created by a company should be required to be registered with the Registrar of Companies. A similar proposal was made to the Greene Committee, who rejected it on the ground that "its adoption (particularly in the case of commercial

documents) would destroy in a large measure one of the most important methods by which companies obtain financial assistance" (paragraph 65 of their Report). We agree with this view and would reject the proposal. It has been pointed out to us, however, that charges on shares are now becoming increasingly common and it has been suggested that they should be made registrable. A company which carries on its business through branches and raises a loan on the security of a charge on the assets used by one of those branches is required to register the charge if it comprises, for example, book debts or real property; but if a company carrying on business through subsidiaries raises money by charging its shares in one of the subsidiaries, the charge does not need to be registered. This is clearly anomalous. We do not think all charges on shares should be registered: this would be open to the objections made by the Greene Committee mentioned above, but we think section 95 (2) should be extended to cover charges created by a company over any shares held by it in a subsidiary.

302. Section 95 requires the delivery to the Registrar of Companies not only of the prescribed particulars of every registrable charge but the instrument (if any) by which such a charge is created or evidenced. (In Scotland a copy is required to be delivered.) Under section 98 the Registrar is required to enter in his register of charges, *inter alia*, "short particulars of the property charged" and to give a certificate of registration. The instrument of charge is not retained by the Registrar. It is used to check the prescribed particulars and is then returned to the person who lodged it together with the certificate of registration. We understand that the Registrar has been advised that the effect of these provisions is to impose upon him an absolute duty to enter on the register the effect of every instrument of charge delivered to him under section 95. Thus, he may receive an instrument of charge which is extremely complicated or is obscurely drafted, but in fact creates both a specific charge on land and a floating charge over the remaining assets of the company, although the prescribed particulars furnished to him may mention only the fixed charge; if he fails to detect the existence of the floating charge and therefore omits any reference to it from his register, he may be liable to anyone who suffers loss in consequence of the omission. We think this is an unreasonable burden to impose on the Registrar. It should be made clear that the Registrar has met his responsibilities in the matter if the register of charges carries an accurate copy of the particulars lodged and the

instrument of charge (or a copy thereof) should no longer be required to be delivered to the Registrar. To ensure that the particulars delivered to the Registrar are accurate we suggest that they should be required to be signed by both the chargee and the chargor.

303. Section 99 provides that a company shall cause a copy of every certificate of registration given under section 98 to be endorsed on every debenture or certificate of debenture stock which is issued by the company and the payment of which is secured by the charge so registered. We understand that this requirement causes difficulties especially, for example, when an issue of debentures by a holding company is secured by a large number of charges on the assets of its subsidiaries. We see no need for the provision and think that it should be repealed.

304. We agree with certain criticisms which have been made of sections 96, 101, 102, 106 and 435 and we make recommendations to deal with them in paragraph 306 (i) to (m) below.

305. Finally, we would refer to the Eighth Report of the Law Reform Committee for Scotland, which dealt with the constitution of security over moveable property and with floating charges, and the consequent Companies (Floating Charges) (Scotland) Act, 1961. The resultant changes in the law relating to the registration of charges created by Scottish companies still leave some differences from the law relating to English companies. Differences in the general law of the two countries no doubt account for some of these differences but we hope that when a new Companies Act is being drafted the two sets of registration provisions will be assimilated so far as practicable, to avoid duplication of entries and to ensure that the entries in the English register, relating to an English company, and those in the Scottish register, relating to a Scottish company, relate to all charges registrable under the laws of both countries.

306. We recommend that:

(a) a company which issues a series of debentures ranking *parri passu* or debenture stock not transferable by delivery should be required to keep a register of the holders of such debentures or debenture stock;

(b) section 87 should be amended to require copies of the register of debenture holders, or of any part thereof, or of the trust instrument to be supplied within ten days of the receipt by the company of the request, and the Board of Trade should be empowered to fix maximum charges, by statutory instrument, for supplying copies (in place of the maximum charge at present prescribed in section 87);

(c) where provision is made in respect of a series of debentures (or debenture stock) for meetings of debenture holders, provisions on the lines of sections 132, 135, 136,

137 and 138 (meetings of shareholders), *mutatis mutandis* should apply;

(d) section 369 (1) should be extended to empower the Court to give the same directions and make the same orders on the application of a debenture holder as it can now make on the application of a receiver;

(e) the Court should be empowered to relieve a receiver appointed under an invalid charge or in circumstances that do not justify such appointment, wholly or in part, from any liability he may incur in respect of anything done or omitted to be done by him while purporting to act as receiver, so long as the act or omission would have been proper had his appointment been valid; the Court should be empowered to hold the person making the appointment liable to the extent that the receiver is relieved from liability by the Court;

(f) a charge on shares held by a company in a subsidiary should be made registrable under section 95 (2);

(g) section 95 (1) should no longer require the delivery to the Registrar of Companies of the instrument creating or evidencing a charge

(or a copy thereof); but the prescribed particulars should not be accepted for registration unless signed by both the chargee and the chargor;

(h) section 99 (endorsement of certificate of registration on debentures) should be repealed;

(i) section 96 should be amended to specify the time within which a company must deliver documents in connexion with the registration of a charge and the penalty imposed by subsection (3) should be a single fine;

(j) section 101 should be amended It provide that an extension of time granted by the Court may be made on the terms that such extension is without prejudice to any liability for default already incurred by the company or its officers;

(k) section 102 should be extended to apply to a person entering into possession as a mortgagee;

(l) section 106 should be extended to require the registration of charges already existing and affecting, or capable of affecting, the English property of a company incorporated outside England which establishes a place of business in England:

(m) the bodies corporate which by virtue of section 435 are already required to comply with certain provisions of the Act should be required to comply with the provisions of Part 111 relating to the registration of charges;

(n) the system of registration of charges in England and Scotland should, so far as practicable, be assimilated so as to avoid duplication of entries and to ensure that the entries in the English register, relating to an English company, and those in the Scottish register, relating to a Scottish

company, relate to all charges registrable under the laws of both countries.

## CHAPTER IX

### UNIT TRUSTS

307. Apart from one or two experiments of earlier date the unit trust movement in this country began in the 1930's. Between 1931 and the outbreak of the second world war unit trusts increased rapidly in popularity and by 1939 there were nearly 100 of them with total assets of some £80m. In 1936 a Committee, under the Chairmanship of Sir Alan Anderson, M.P., was appointed by the President of the Board of Trade "to enquire into Fixed Trusts in all their aspects, and to report what action, if any, is desirable in the public interest". The Committee, who decided that their enquiry must cover flexible as well as fixed trusts, pointed out that there were certain dangers inherent in this form of investment and concluded that the surest safeguards for the small investor were full information about the constitution and operation of trusts and adequate means of ensuring the reliability of trustees and managers.

308. The present provisions for the control of unit trusts were originally included, at the Committee stage, in the Prevention of Fraud (Investments) Act, 1939, and have since been re-enacted and consolidated in the Prevention of Fraud (Investments) Act, 1958. It is illegal under the Act to offer the units of an unauthorised trust to the public by circular. Section 17 provides that the Board of Trade may authorise a unit trust scheme if satisfied that conditions to the following effect are fulfilled:

(i) that the trustee and manager are incorporated under the law of the United Kingdom and have places of business in Great Britain, that the trustee corporation has an issued capital of not less than £500,000, of which not less than £250,000 has been paid up, and that the assets of the trustee corporation are sufficient to meet its liabilities, including liabilities in respect of the repayment of its capital (or alternatively that a company holding more than four-fifths of the capital of the trustee corporation satisfies the above requirements);

(ii) that the manager is independent of the trustee;

(iii) that there is a trust deed providing for the matters specified in the First Schedule to the Act to the satisfaction of the Board of Trade.

The Board of Trade have pointed out that, since section 17 states that the Board *may* - not *shall* - authorise trusts when these conditions are satisfied, they may refuse to authorise a unit trust scheme even though it complies fully with the above conditions. And, indeed, the Board of Trade do require as a further condition of their authorisation that the trust deed shall provide to the Board's satisfaction for a number of matters in addition to those set out in the First Schedule to the Act.

309. In our opinion it was not unreasonable, in early attempts at control, that these wide discretionary powers should have been vested in the Board of Trade since it would probably have been very difficult at that stage to devise clearly defined and limited statutory rules. Moreover the present system has in practice worked reasonably well and the Unit Trust movement has an enviable record of fair and honest dealing over the whole of its life. We also think that the Board of Trade has exercised their wide powers with moderation. Nevertheless, we have come to the conclusion that the present system is open to objection on two counts. First, on principle, we doubt the wisdom of leaving control completely within the unfettered discretion of the Board of Trade: we think that it should now be possible for the latter, with the experience of the last thirty years, to draft precise rules for unit trusts which would be of general application and subject to Parliamentary approval. Secondly, in practice, we think there is some substance in the complaint of the Association of Unit Trust Managers that these absolute powers have led the Board perhaps to concern themselves too much with the detailed arrangements of unit trusts. Thus, it is said, tends to embarrass the managers owing to delays in the settlement of matters of relatively minor importance and uncertainty as to the new requirements which the Board may think fit to impose from time to time. For example, we do not think it is necessary to require as a condition of authorisation, as the Board of Trade have informed us that they do, that trusts should distribute dividends to unit holders at least twice a year.

310. The Association of Unit Trust Managers have suggested that the present difficulties would be met by a new Unit Trust Act which, *inter alia*, included a model form of Trust Deed. It would then be possible for a unit trust scheme to be constituted by adopting the model deed without submitting it for prior approval by the Board of Trade, who would only be required to consider variations from the model. However, as the Board of Trade have pointed out in their evidence to us, a statutory model trust deed would only be a convenience if the trust deeds submitted to them contained few variations from the model; they doubted whether there would be the necessary conformity and for the same reason we do not recommend its adoption.

*Proposed new system of control*

311. We would favour a new system of control on the lines set out below in substitution for the existing provisions for the authorisation of unit trusts. We also agree with the representatives of the Association of Unit Trust Managers that it is unfortunate that control should be exercised under an Act primarily designed to prevent share pushing; but we hope that our suggestions in Chapter VII for consolidation of certain provisions of the Prevention of Fraud (Investments) Act with the Companies Act, and for embodying the provisions relating to unit trusts in a new part to the Companies Act, will meet this objection.

312. The definition of "unit trust scheme" in the Prevention of Fraud (Investments) Act is very wide and covers not only those schemes in which the underlying assets consist of securities and cash but also those, such as "commodity pools", in which it consists of other forms of property. We

propose that the definition of a unit trust scheme should in future cover only those schemes in which the underlying assets consist of securities and cash. (We understand that the Board of Trade have only authorised schemes of this sort.) Such schemes, once registered, would be free from the prohibition against carrying on the business of dealing in securities and issuing circulars imposed by the Prevention of Fraud (Investments) Act. All unregistered unit trusts and schemes not within the proposed definition of a unit trust should continue to be subject to the provisions of the Prevention of Fraud (Investments) Act amended as necessary to meet our recommendations in Chapter VII.

313. The Board of Trade would be required to register by name a unit trust scheme on written application by the manager and trustee, provided that the Board of Trade were satisfied that:

(i) the manager and trustee were qualified to operate a unit trust. The necessary qualifications are discussed in paragraph 316 below;

(ii) the trust deed between the manager and the trustee, copies of which, and of all supplemental deeds, would be deposited with the Board, included a covenant in a form prescribed by the Act and dealt with such matters (e.g. management charges) as were statutorily required to be dealt with in the trust deed. (The covenant would be to the effect that the scheme would be managed and administered in conformity with the requirements of the Act and of any statutory instruments made thereunder for the time being in force, and that the provisions of the trust deed were only to take effect if and so far as they were not inconsistent with the statutory requirements.);

(iii) the name of the unit trust scheme was not undesirable.

Suitable provisions would have to be made for the registration of unit trust schemes at present authorised under the Prevention of Fraud (Investments) Act. In this connexion we suggest that existing unit trust schemes should not be

required, as a condition of registration, to change a trustee or manager who qualifies under the existing requirements but fails to qualify under the proposed new requirements.

314. Under the new system, the Board of Trade would be responsible for registering unit trust schemes and for issuing detailed requirements, by statutory instruments, in respect of certain matters which would be specified in the Act and which we discuss in paragraph 324 below. The Board of Trade would also have power by statutory instrument to add to, or subtract from, the matters in respect of which they could impose detailed requirements. Thus the matters to be controlled and the controls imposed would be exhaustively stated in the Act itself or in statutory instruments made thereunder. It would be the duty of the manager and trustee, in the execution of their respective offices, to ensure that their unit trust scheme was registered and was managed and administered in accordance with the statutory requirements. Subject to this over-riding obligation, which would be expressed in the covenant included in the trust deed, the Act would allow the trust deed constituting any unit trust to contain such powers

and provisions for the management and administration of the trust as might be agreed between the manager and trustee provided that as we recommend in paragraph 329 (q) below the maximum charge for management expenses was stated. The Act would impose penalties for infringements of the statutory requirements and should also make clear that unit holders had the same civil remedies for a breach by a manager or trustee of a statutory requirement which is not specifically included in the trust deed as for a breach of a provision in the trust deed.

315. We have considered whether the Board of Trade might be given power to exempt particular trusts from any or all of the statutory requirements. It may be argued that such a power would introduce a desirable element of flexibility into our proposals but, on the other hand, it would restore discretionary powers to the Board of Trade with the disadvantage to which we have already referred. We would hope that it would not prove necessary to give a power of exemption to the Board. But a decision on this matter can hardly be taken until the final shape of the statutory requirements can more clearly be seen.

#### *Managers and trustees*

316. We think the Act should provide that both the manager and the trustee of a registered unit trust should be suitable persons, in the opinion of the Board of Trade, to operate such a trust. The Act might set out specific grounds upon which the Board of Trade might decide that managers or trustees were unsuitable, e.g. because their directors or other officers were persons who had been convicted of an offence involving fraud or dishonesty, but the Board should also have a general power so to decide on any other grounds. The Act should further provide that:

(i) the trustee should be a body corporate with a paid up capital and net assets of at least £1m, which is incorporated in the United Kingdom and has a place of business in Great Britain and is required to file accounts with the Registrar of Companies;

(ii) the manager should be a body corporate which in incorporated in the United Kingdom and has a place of business in Great Britain and is required to file accounts with the Registrar of Companies;

(iii) the manager and trustee should be independent of one another;

(iv) any provision in the trust deed should be void in so far as it would have the effect of exempting the trustee from, or indemnifying him against, liability for breach of trust where he failed to show the degree of care and diligence required of him as trustee (cf. section 88 (1) of the Companies Act). This should not deprive a trustee of any exemption from, or right to be indemnified against, anything done or omitted to be done by him before the new Act comes into force.

#### *Information for unit holders*

317. We attach the greatest importance to the provision of full information, in a simple form of prospectus and in the accounts, as the surest

means of protecting investors. As we have pointed out in another connexion, the fact that individual investors may not always be able to interpret and analyse the information provided does not detract from its usefulness, since investment advisers and financial journalists will also have access to the information and be able to comment and give guidance to prospective investors. Accordingly we recommend that unit trust managers and trustees should be required by the Act to accept applications for units from new investors only on application forms issued with a prospectus, the terms of which had been approved by the trustee and a copy of which had been filed with the Board of Trade. The information to be included in such a prospectus should be laid down by the Board of Trade by statutory instrument: the detailed requirements are considered further in paragraph 324 (vi). We have confined our recommendation to applications from new investors because we were informed that it was a common practice for investors to purchase units by regular instruments as a means of saving. In these circumstances we think it would be unduly burdensome to require that an application form issued with a prospectus should be completed for each purchase.

318. The Act should all provide that:

(a) the manager and/or trustee should be under a statutory obligation to ensure that a register of unit holders and proper books of account, relating to the trust are kept;

(b) half-yearly and annual accounts should be filed with the Board of Trade and at least the annual accounts should be circulated to unit holders: the accounts should be required to give a true and fair view. The form of accounts should be laid down by statutory instrument (see paragraph 324 (ix) below);

(c) the requirements for qualification for appointment as auditor, the auditor's right of access to records and information and the auditor's report should be similar to the requirements in the Companies Act;

(d) the auditor's appointment should require the approval of the trustee.

*Control of managers' charges*

319. The Act should provide that the trust deed should state the maximum level of charges which may be made by the manager, distinguishing between the maximum permitted initial charge, expressed as a percentage of the value of the unit, and the maximum permitted annual charge, expressed as a percentage of the value of the trust fund. Provided this is done we think it is no longer necessary that the level of charges should be controlled by the Board of Trade. The Anderson Committee did not recommend such control, and it does not appear to have been the original intention of Parliament that it should be imposed; at all events managers' charges are not specifically mentioned in the First Schedule to the Prevention of Fraud (Investments) Act, nor was the possibility of limiting them discussed in the Parliamentary debates on the original Bill. The Board of Trade apparently first introduced control over charges in 1950 when price control of many commodities and services was common practice.

Later they seem to have been concerned to prevent door-to-door canvassing for sales, a relatively expensive method of selling units which is not directly prohibited by the present Act.

320. It has been pointed out that it is difficult to fix fair and reasonable charges because, among other things, the cost of running a unit trust varies considerably according both to the size of the trust and to the average size of individual holdings of units. If it were thought necessary to continue this control it might perhaps be possible to meet this difficulty by a sliding scale of permitted charges. But we do not think that control of charges is in itself either necessary or desirable. It has been argued that irrespective of their relative merits as investments those trusts which spent most on advertising (and as a result, perhaps, imposed the highest charges) would attract the most investors. We do not agree that small investors are as unsophisticated and ill-informed as this argument would suggest, and, bearing in mind that exceptionally high charges would materially reduce the advertised yield and no doubt attract press comment, we think that investors would be adequately safeguarded by competition between trusts if information about the maximum charge permitted under the terms of the trust deed were required to be published in the prospects, and if door-to-door canvassing were prohibited outright as we suggest in paragraph 324 (viii) below.

321. We do not think that the establishment of a management fund to guarantee the future costs of management should continue to be a statutory requirement. As representatives of the unit trust movement have pointed out. This requirement increases the initial charge and, since we understand that trust deeds normally give the managers the right to terminate a trust which is uneconomically small, is unnecessary.

### *Inspectors*

322. In substitution for the existing statutory provisions as to inspection in section 12 of the Prevention of Fraud (Investments) Act the new Act should provide for the appointment of inspectors by the Board of Trade to investigate the affairs of a registered unit trust on their own

initiative, or on application by the manager or trustee, or by holders of at least 10 per cent. of the units in issue provided the Board of Trade are satisfied that an application by the latter is not merely vexatious.

### *Cancellation of registration*

323. The Board of Trade should have power to cancel the registration of a unit trust if the manager or trustee had ceased to fulfil the conditions suggested in paragraph 316 or had otherwise become unsuitable persons to operate a unit trust scheme or the Board of Trade were satisfied that the scheme was not being operated in accordance with the statutory requirements and that it was therefore in the public interest to cancel the registration. On such cancellation the scheme would be controlled by the Prevention of Fraud (Investments) Act and, *inter alia*, it would be illegal thereafter to offer units to the public. The Board should have power in these circumstances to appoint a new manager or trustee of the trust if satisfied that this was necessary to protect the interests of existing unit holders. Before cancelling the registration of any unit trust the Board should

be required to serve written notice on the manager and trustee that they were considering cancellation of the registration, specifying the grounds on which this action was being contemplated and inviting the manager and trustee to make any representations within, say, one month. The Board should be empowered to regulate transactions in units by the manager during this period and should be required to take into consideration any representations made by the manager and trustee before deciding whether or not to cancel the registration.

#### *Powers of the Board of Trade*

324. We think that the Act should empower the Board of Trade to impose requirements by statutory instrument on all unit trusts in respect of the following matters:

(i) calculation of the manager's bid and offer prices of units and of their yield;

(ii) securing that all units issued are or will be covered by assets vested in the trustees;

(iii) rights of unit holders to require the repurchase of their units at the bid price calculated in accordance with the statutory requirements. Repurchase bargains below such bid prices should be statutorily prohibited;

(iv) prohibiting the managers from making profits for themselves from transactions in the underlying securities of the trust either on its formation or subsequently; and requiring the managers to disclose any profits or losses which they make through dealing in, or holding, units. Subject to such requirements the managers should, in our view, be free to act as principals or agents in respect of the units and the underlying securities of the trust;

(v) enabling the trustee to remove a manager, if the trustee has certified that it is in the interests of the unlit holders that should do so;

(vi) information to be included in the prospectus. We think that this would include:

(a) the names of the manager and trustee and the auditor; if the manager is the subsidiary of another company it should be enquire to state the name of its holding company and of its ultimate holding company;

(b) details of the maximum charges permitted by the trust deed, divided between initial and annual charges;

(c) details of the investments held as at a date not earlier than that of the last half-yearly accounts to have been filed with the Board of Trade; an explanation of the investment policy followed, including any provisions in the trust deed as to:

(i) the minimum number of different investments to be held in the trust at any one time;

(ii) the maximum percentage of the trust funds to be invested in any one security;

(iii) the maximum percentage of the total in issue of any one security to be held by the trust;

(vi) any prohibition or restriction on holdings of unquoted securities;

(d) particulars of distributions made to unit holders over the last three years;

(e) where the trust deed can be inspected;

(vii) advertising by unit trust managers in the press, by circular or by radio, television or cinema. The terms of any advertisement should also continue to require approval by the trustees. In this connexion our attention has been drawn to the practice of making "block offers", which may be simply described as offers of a fixed number of units at a fixed price for a fixed period. Several witnesses have criticised such offers on the ground that they may lead the intending investor to believe that he is being offered an advantageous bargain which he will lose unless he accepts fit within the period stated, whereas in fact units will continue after the period expires to be available for purchase at the current price and the terms accorded to an investor who buys on the strength of the block offer are not substantially better than those obtainable by one who buys in the ordinary course. On the other hand it is said that the block offer serves a useful and indeed necessary purpose in the formation of new trusts and the building up of existing ones by enabling wider advertising to be undertaken, and, subject to proper safeguards, should be allowed to continue. We think that the criticisms above stated will be sufficiently met if the Board of Trade are empowered, under the new Act, to impose regulations to secure that

(a) a block offer is not made on exceptionally advantageous terms to newcomers at the expense of existing unit holders (the Board of Trade at present control this):

(b) that any prospectus or advertisement accompanying a block offer should state clearly that the offer price is based on the value of the underlying securities acquired or to be acquired and that after the period of the block offer units will continue to be available at the current offer price which may be more or less than the block offer price;

(viii) prohibition of door-to-door canvassing for sales. The Report of the Greene Committee on Company Law Amendment (Cmd. 2657) said, in relation to this method of selling shares

"we consider that 'share hawking' of this description cannot be justified and its prohibition would not interfere with any legitimate business. The absence of any check upon the verbal statements of the 'hawker', generally an agent paid by commission, coupled with the fact that the persons approached are in many, if not most, instances without any business experience, opens the door to the gravest abuses."

The Board of Trade Rules for the Conduct of Licensed Dealers contain restrictions on unsolicited calls by licensed dealers in securities and we think that similar restrictions should obtain in the case of unit trusts to prevent abuses of the kind referred to by the Greene Committee;

(ix) the form of accounts to be filed with the Board of Trade and to be circulated to unit holders. We suggest that the statutory requirements should be based on the detailed recommendations made to us by the Institute of Chartered Accountants in England and Wales. A full list of investments held by the trust should be required to be attached to the accounts.

#### *Unit trusts formed overseas*

325. As we have already noted unit trust schemes formed by trustees or managers incorporated outside the United Kingdom cannot at present be authorised by the Board of Trade. We have considered whether any special provisions could or should be made whereby such unit trusts might be enabled to register under the new Act. We consider, however, that it is an important safeguard for investors that the manager and trustee should be subject to control in the United Kingdom. Moreover, any relaxation of the present rule might enable United Kingdom residents to evade the requirements by forming trustee and management companies in countries which have no controlling legislation, and then establishing a place of business in the United Kingdom. We do not therefore recommend any relaxation of the provisions to enable a unit trust formed overseas to register in this country.

#### *Open-ended investment companies*

326. In the United States and some other countries investment companies have been incorporated which buy back issued shares from members on demand and thus in effect carry on a very similar business to unit trusts. If, as in the United States, companies of every sort could buy back shares in issue, there would seem no good reason for prohibiting such repurchase by

investment companies. But we have recommended elsewhere against a general innovation of this kind. We have had, therefore, to consider whether to recommend that investment companies alone should have the right to re-purchase their shares.

327. One of the principal advantages over unit trusts claimed in evidence for such "open-ended" companies is that they avoid the need for a trustee and, by concentrating the functions of manager and trustee in the hands of the directors of the open-ended company, reduce the costs of operation. It is also pointed out that the directors of an open-ended company are, more clearly than the managers of a unit trust, precluded by their fiduciary relationship to their shareholders from acting as principals in dealings in their own company's shares or the underlying securities; and this has been commended to us as the most satisfactory arrangement. However, we agree with those who maintain that the trustee is an important and necessary part of the structure of organisations carrying on this type of business for small investors and we have made recommendations above

which we hope will increase the necessary qualifications and the responsibilities of trustees. If the trustee is to remain, as we think he should, even in an open-ended investment company, we can see little point in introducing the rather complex legislation necessary to provide for, and control, the open-ended investment company. Moreover, we have suggested that, subject to certain conditions which should be prescribed by law, there is no harm in managers acting as principals. If open-ended investment companies cannot be incorporated to operate in this country we do not think that open-ended investment companies, incorporated abroad, should be permitted to circulate generally in this country a prospectus offering shares for subscription. We would not, however, curtail in any way the discretion at present exercised by stock exchanges in this country to grant quotations for such shares and we would exempt, from the general prohibition on circularisation of a prospectus, offers of shares to existing shareholders in this country.

#### *Investment clubs*

328. Our attention has been drawn to the development in recent years of investment clubs. We understand that while the activities of such clubs are not, as such, subject to any statutory control, they are subject to the provisions of the Prevention of Fraud (Investments) Act in so far as their activities involve circularisation; and that clubs of the type where two or more members hold securities on behalf of the rest may come within the definition of unauthorised unit trust schemes, so that circularisation on their behalf would be prohibited even to persons authorised to deal in securities. We have received no evidence about the activities of these clubs and we make no recommendation for any change in the law concerning them.

329. **We recommend that:**

**(a) the provisions of the Prevention of Fraud (Investments) Act empowering the Board of Trade to authorise unit trust should be repealed;**

(b) the definition of a "unit trust scheme" should in future cover only schemes whose underlying assets consist of securities and cash;

(c) such unit trusts, if registered with the Board of Trade, should be free from the prohibition on carrying on the business of dealing in securities and issuing circulars now imposed by the Prevention of Fraud (Investments) Act. Unregistered unit trusts and schemes not within the proposed definition of a unit trust would continue to be subject to the Prevention of Fraud (Investments) Act;

(d) the Board of Trade should be required to register a unit trust by name on application by the manager and trustee, provided that:

(i) they were satisfied that the latter were suitable persons to operate a unit trust as well as falling within the categories described in (i) and (j) below

(ii) the trust deed, between the manager and the trustee, a copy of which, together with copies of any supplemental trust deeds, had been deposited with the Board, included a covenant in a form prescribed by the Act and dealt with such matter

as were statutorily required to be dealt with in the trust deed. The covenant would be to the effect that the unit trust scheme would be operated in conformity with the requirements of the Act and of any statutory instruments made thereunder for the time being in force and that the trust deed was only to take effect if and so far as its provisions were not inconsistent with the statutory requirements;

(iii) the name of the trust was not undesirable;

(e) suitable provisions should be made for the registration of unit trust schemes at present authorised under the Prevention of Fraud (Investments) Act. In this connexion existing unit trust schemes should not be required, as a condition of registration, to change a trustee or manager who qualifies under the existing requirements but fails to qualify under the proposed new requirements;

(f) the Board of Trade should have power to impose requirements by statutory instrument on all registered unit trusts in respect of a number of matters to be specified in the Act. Paragraph 324 sets out the matters which the Committee recommend should be so specified. The Board of Trade might be empowered to add to these specified matter by statutory instrument;

(g) the Board of Trade should if necessary be empowered to exempt particular unit trusts from any or all of the statutory requirements;

(h) the managers and trustees, within their respective spheres, would be responsible for operating the trusts in accordance with the statutory, requirement. There would be penalties for infringements of the requirements and the Act should also make clear that unit holders had the same civil remedies for a breach by a manager or trustee of a statutory requirement which was not specifically included in a trust deed as for a breach of a provision in the trust deed;

(i) the trustee should be a body corporate which is incorporated in the United Kingdom and has a place of business in Great Britain, with a paid up capital and net assets of at least £1m., and is required to the accounts with the Registrar of Companies;

(j) the manager should be a body corporate which is incorporated in the United Kingdom and has a place of business in Great Britain and is required to file accounts with the Registrar of Companies;

(k) the manager and trustee should be required to be independent of one another;

(l) nothing in the trust deed should exempt the trustee from, or indemnify him against, breaches of trust through lack of care or diligence (cf. section 88 (1) of the Companies Act. This provision should apply to existing trust deeds but should not deprive a trustee of any exemption from or right to be indemnified against anything done or omitted to be done by him before the new Act comes into force;

(m) unit trust managers and trustees should be required to accept applications from new investors only on application forms issued

with a prospectus which complied with the statutory requirements and had been approved by the trustee, and a copy of which had been filed with the Registrar;

(n) a register of unit holders and proper books of account relating to the affairs of the trust should be required to be kept in respect of each registered unit trust scheme;

(o) half-yearly and annual accounts should be filed with the Board of Trade and annual accounts, at least, should be circulated to unit holders. The accounts should be required to give a true and fair view;

(p) the provisions concerning qualification for appointment as auditor, the auditor's right of access to records and information, and the auditor's report should be similar to the requirements in the Companies Act. The auditor's appointment should also require the approval of the trustee;

(q) the trust deed should be required to stipulate the maximum level of charges which may be imposed by the manager, distinguishing between the initial charge, expressed as a percentage of the value of the unit, and the annual charge, expressed as a percentage of the trust fund. There should be no statutory control over the level of charges; nor should the establishment of a management fund to guarantee the future costs of management be required;

(r) the Board of Trade should have power to appoint inspectors to investigate the affairs of unit trusts on their own initiative, on application by the manager or trustee, or on application by holders of at least 10 per cent. of the units in issue, provided that the Board were satisfied that an application by the latter was not merely vexatious;

(s) the Board of Trade should have power to cancel the registration of a unit trust if the manager or trustee had ceased to be a suitable person to operate a unit trust scheme

(see paragraph 329 (d) (i) above) or the Board were satisfied that the scheme was not being operated in accordance with the statutory requirements, and that it was therefore in the public interest to cancel the registration. The scheme would thereafter be subject to control under the Prevention of Fraud (Investments) Act. The Board of Trade should be required to give notice to the manager and trustee of a unit trust scheme that they were contemplating cancellation of its registration, and the Board should, before taking a decision on the matter, consider any observations made by the manager and trustee. (During the warning period the Board should have power to regulate transactions in units by the manager);

(t) the Board of Trade should have power to appoint a new manager or trustee of a trust whose registration had been cancelled, if they were satisfied that this was necessary to protect the interests of the existing unit holders;

(u) the law should not permit the incorporation in this country of "open-ended" investment companies, nor should such companies

which have been incorporated abroad be permitted to circulate generally in this country a prospectus offering shares for subscription. Shares in such companies should continue, at the discretion of the stock exchanges concerned, to be permitted to be quoted on stock exchanges in this country and offers of shares to existing shareholders should be exempted from the general prohibition on circularisation of a prospectus.

## CHAPTER X

### ACCOUNTS

330. This section of our Report deals first with the general requirements in the Act about the annual accounts and discusses the principles which should be followed in presenting company accounts. Secondly, we consider the law relating to the distribution of profits and suggest certain respects in which the existing law should be clarified or amended. Thirdly, we recommend certain exemptions affecting the filed accounts of unquoted companies. Fourthly, we consider the provisions of the Eighth Schedule to the Act, dealing first with the balance sheet and then with the profit and loss account: references to the balance sheet and profit and loss account should be taken as including, where appropriate, notes thereon. We then make recommendations about the exemptions at present extended to banking and discount companies, insurances companies and shipping companies. Finally, we deal with a few miscellaneous matters.

#### *General*

331. The accounting provisions of the Act were a great advance on previous requirements and the evidence indicates that, on the whole, they have worked remarkably well. There is, however, still a certain amount of dissatisfaction with the amount and kind of information given in the accounts of some companies and we have received proposals of the most varied character for amending the statutory provisions.

332. The Act at present imposes a dual obligation on directors. Section 149 (1) requires every balance sheet to give a true and fair view of the state of affairs of the company as at the end of its financial year, while section 149 (2) requires every balance sheet to give the detailed information specified in the Eighth Schedule. There are similar requirements for the profit and loss account. In our view the general scheme of the Act in this respect is the right one, namely to indicate in general terms the objectives

and the standard of disclosure required and also to prescribe certain specific information that must be given. The formula "true and fair" seems to us satisfactory as an indication of the required standard, while it makes for certainty to prescribe certain specific information which the law regards as the minimum necessary for the purpose of attaining that standard. It seems to be generally understood that the accounts may not lawfully omit any of the information specified in the Eighth Schedule, without the authority of the Board of Trade; but we doubt if it is always appreciated that accounts which comply strictly with the requirements of the Eighth Schedule (and of sections 196 and 197) may still fail to give the true and fair view required by the Act, although we think this is the effect of section 149 (3), which provides that the duty to give the detailed information required by the Eighth Schedule is without prejudice to the general duty to give a true and fair view.

333. The criticism made by those who think that the accounting provisions off the Act are defective raise very difficult questions. Some (but by no means all) of this criticism seems to us to be based on the idea that the function of a company's balance sheet is to show the directors' opinion of the worth of its undertaking or of its assets at the date as at which the balance sheet is made up. As the Cohen Committee pointed out at paragraph 98 of their Report, that is not the function of a balance sheet and indeed a balance sheet prepared on that basis could be seriously misleading except when the company is about to be liquidated. The proper function is admirably explained in the following passage from the Recommendations on Accounting Principles issued to its members by the Institute of Chartered Accountants in England and Wales (which we quote at length because we think that the function of company accounts may not be fully appreciated by those investors unfamiliar with accounting principles and practice):

"The primary purpose of the annual accounts off a business is to present information to the proprietors, showing how their funds have been utilised and the profits derived from such use. It has long been accepted in accounting practice that a balance sheet prepared for this purpose is an historical record and not a statement of current worth. Stated briefly its function is to show in monetary terms the capital, reserves and liabilities of a business at the date as at which it is prepared and the manner in which the total moneys representing them have been distributed over the several types of assets. Similarly a profit and loss account is an historical record, it shows as the profit or loss the difference between the revenue for the period covered by the account: and the expenditure chargeable in that period, including charges or the amortisation of capital expenditure. Revenue and expenditure are brought into the account at their recorded monetary amounts. This basis of accounting is frequently described as the historical cost basis ...

An important feature of the historical cost basis of preparing annual accounts is that it reduces to a minimum the extent to which the accounts can be affected by the personal opinions of those responsible for them. For example, the cost of a fixed asset is known so that in calculating depreciation provisions based on that cost the only respects in which estimates enter into the matter are in relation to the probable useful life of the asset and its realisable value, if any, at the end of its

life. Depreciation provisions computed on this basis are intended, by making charges against revenue over the useful life of an asset, to amortise the capital expenditure incurred in acquiring it. For this purpose, estimates of current value or of replacement cost do not arise. Again, there are limits within which estimates and opinions can properly operate in relation to stock-in-trade, provided the bases of calculation, are sound in principle and used consistently."

In our view this "historical cost" basis of accounting, which was endorsed by the Cohen Committee and is used almost universally, should continue to be the basis on which company accounts are prepared.

334. Nevertheless, the law does not and should not insist upon a rigid and uniform application of the historical cost principle in all circumstances. The Act already requires the current value of some current assets to be shown and permits a valuation of fixed assets. Accounts prepared on the historical cost basis may need m be accompanied by supplementary information in

order to give shareholders the true and fair view required by the Act. It is impossible to describe in general terms all the circumstances in which this will be so and it is manifestly impossible to devise a list of specific requirements which will produce the same result. We indicate some additions which could usefully be made to the Eighth Schedule and to the information required to be given in the directors' report for this purpose, but these cannot deal with more than part of the problem. Whether the information provided in the accounts is enough to give a true and fair view is to some extent a matter of the opinion of the directors based on the circumstances of a particular company. In the last resort the auditor must decide whether he is prepared to state that in his opinion the accounts give a true and fair view; if all the necessary information is not given the auditor is required to qualify his report accordingly. The Recommendations on Accounting Principles periodically issued by the Institute of Chartered Accountants in England and Wales to their members have already done much to ensure that the standards of accounting are reasonably uniform and constantly rising. These recommendations are based on close and constant study of the relevant problems, which are ever changing, and it is primarily to the initiative of the professional associations that we must look if the general principles of the Act are to be effectively applied in practice.

### **Distribution of Profits**

335. We have given careful consideration to the desirability of incorporating in any new legislation some general provisions relating to the ascertain-merit and distribution of profits. The method by which the profit of a company are to be ascertained depends on circumstances which may vary widely as between one company and another. The only general rule that can with any certainty be deduced from the decisions of the Court in the cases in which this matter has been considered is that profits must be ascertained by reference to normal standards of commercial prudence. We have reached the conclusion that it would be impracticable to formulate a code of precise statutory rules capable of dealing adequately with every possible case. At the same time we think that any new legislation should include special rules providing for the cases discussed in the following paragraphs.

*Distribution of unrealised capital surplus*

336. There are differing legal decisions on the question whether or not a company is permitted to distribute in cash or in the form of specific assets a surplus resulting from a revaluation of its unrealised fixed asset. We refer to the Scottish case of *Westburn Sugar Refineries Ltd. v. Inland Revenue Commissioners* 1960 S.L.T. 297, which decided that such a surplus was not distributable and the subsequent English case of *Dimbula Valley (Ceylon) Tea Co. Ltd, v. Laurie* [1961] Ch. 353, which decided the opposite.

337. We consider that the law on this point should be settled for the future. Evidence from the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland and

343. In our view the right principle is that the acquiring company should not regard as its own profit (available for distribution to its shareholders) any dividend received from the acquired company which has been paid out of profits which the acquiring company has already paid for in the consideration originally given for the shares of the acquired company. In practice, however, we believe that it would be very difficult to enforce a legal provision expressed in such general terms. We think, therefore, that the Act should contain an overriding provision to the effect that the date as from which the shares may be deemed to have been acquired should in no case be earlier than the close of the latest accounting period of the acquired company before the contract was entered into.

344. To the proposed general rule (that pre-acquisition profits are not to be treated as profits of the acquiring company) there should in our view be three exceptions. First the existing exception (in paragraph 15 (5) of the Eighth Schedule) in favour of inter-group acquisitions should be maintained. Secondly, there should be an exception for shares purchased by a company if the directors are of the opinion that the dividend eventually received in respect of a period before the acquisition is not significant in relation to the assets or profits of the acquiring company as for example in the case of an investment trust or property company. Thirdly, there should be a limited exception when 90 per cent. or more of the equity share capital of one or more companies is acquired in return for shares in a new acquiring company.

345. Although in principle pre-acquisition profits attributable to shares acquired in return for shares in the acquiring company are capital in the hands of the acquiring company just as much as if those shares had been acquired for cash, the strict application of this principle can operate unreasonably on a reconstruction or amalgamation which takes the form of setting up a new company which acquires more than 90 per cent. of the shares of one or more companies. In such a case the new company will have no reserves available for distribution in dividend if profits temporarily fall although before the reconstruction or amalgamation large reserves might have been available for distribution to the shareholders. In some circumstances, this could operate harshly on the shareholders. We think that in a case of this sort dividends received out of pre-acquisition distributable reserves of any one but (except with the consent of the Court given in the circumstances indicated in paragraph 348 below) not more than

one of the companies acquired should be available for distribution by the parent company. We realise that to many of those who criticise the rigidity of the general rule the exception we now propose may seem unnecessarily restricted. It has been argued that, so long as the shareholders are substantially the same after the amalgamation, there is no need to freeze the distributable pre-acquisition reserves, and the recommendation of the Gedge Committee on this matter (paragraph 72 (10) of their Report) was based on this view. In our view, however, there should be no departure from the general rule beyond that is strictly necessary to avoid possibility of hardship. We think it would be dangerous to extend the exception to amalgamations which do not involve the formation of a new company to act as a holding company:

to do so would enable companies to "buy profits" that is to say, to acquire control of companies with large reserves (represented by large liquid assets) with a view to using those reserves for the purpose of paying large dividends on their own shares thereby giving those shares (albeit only temporarily) an artificially high market value. In any case, we do not think there is any need to extend the exception to such amalgamations; none of the witnesses whom we questioned on this matter produced any evidence that the general rule had caused or was likely to cause serious hardship in such cases. When an existing company acquires the share capital of another company its own revenue reserves will be available if profits temporarily fall. Our proposal is to extend this facility to an amalgamation by means of a new holding company, and thus remove the disability suffered at present by those who select this kind of amalgamation.

346. Even in the circumstances described in paragraph 345 above we would not permit the acquiring company to distribute the pre-acquisition profits of an acquired subsidiary if by so doing it would reduce its own share capital. The concession we propose should, however, be available where the shares of the acquiring company are issued at a premium; but where shares are issued at a premium section 56 now requires the whole amount of the premium to be credited to a share premium account and does not permit any part of it to be distributed in dividends. To give effect to our proposal at paragraph 345, therefore, we think that section 56 should be amended to provide that a new company which has acquired a subsidiary in the circumstances described in paragraph 345 by issuing its own shares at a premium, should not be required to credit the whole amount of the premium to the share premium account, but should be free to credit an amount not exceeding the premium or the pre-acquisition reserves of the subsidiary to another account. The amount thus credited would be used to write down the amount of the investment in the subsidiary (and thus free an equivalent amount for distribution to the members of the holding company) when, and to the extent that, dividends are received by the holding company from the pre-acquisition reserves of the subsidiary. Where the shares issued are shares of no par value there can be no premium, but on grounds of practical convenience we would make a similar exception to the general rule that the whole of the proceeds of the issue of such shares should be credited to the "stated capital account".

347. A holding company must elect to take advantage of this exception before the publication of its first balance sheet after the acquisition and that balance sheet must state to what extent the holding company has elected to treat itself as free to distribute the pre-acquisition reserves of its subsidiary among its members.

348. To meet any exceptional cases of hardship which may arise, especially where more than two companies are concerned, we would give the Court power at any time to permit any company, which had acquired 90 per cent. or more of the equity share capital of one or more companies, to treat as distributable reserves all or any part of any dividend paid to it out of pre-acquisition reserves of the subsidiary companies. The procedure and the conditions upon which the Court should exercise its jurisdiction should be the same as on a reduction of capital.

## *Depreciation*

349. There is at present some doubt whether a company is required by law to make provision for depreciation (or replacement) of its assets in computing its distributable profits. It is the general practice to amortise the cost of wasting assets (such as leasehold properties, plant and machinery and ships, and, in some cases, mining properties) by making an annual charge against earnings or by providing for replacements. But some companies do not make such provision and we think that the law should be amended to make the practice in future obligatory, though exception should be made for companies incorporated before publication of our Report which had made clear in their memoranda or articles or by practice that they proposed to make no provision for depreciation of such assets. In our recommendations about the contents of the profit and loss account in paragraph 397 (a) below we make detailed recommendations about computation of depreciation.

350. We recommend that the Act should be amended to provide in respect of limited companies having a share capital that:

(a) a net realised capital profit may be treated as a distributable profit only if the directors are satisfied that the net aggregate value of the assets remaining after the proposed distribution of that profit will be not less than the book value, so that the share capital and reserves remaining after the distribution will be fully represented by the remaining assets;

(b) a capital surplus arising on the revaluation of unrealised fixed assets should not be directly or indirectly available for distribution in dividend;

(c) past revenue losses should be eliminated before profits of subsequent years are distributable; thus the revenue account of a company should be regarded as a continuous account;

(d) (subject to the exceptions noted at subparagraphs (f) and (g) below) pre-acquisition profits attributable to any shares in another company should not be available for distribution as profits of the acquiring company;

(e) the date as from which the shares may be deemed to have been acquired (for the purposes of (d) above) should in no case be earlier than the close of the latest accounting period of the acquired company before the contract was entered into;

(f) the prohibition mentioned at (d) above should not apply to inter. group acquisitions, nor where the amount of the pre-acquisition profit is not in the opinion of the directors significant;

(g) where a new holding company has acquired 90 per cent. or more of the equity share capital of one or more companies in exchange for its own shares issued at a premium (or for no par value shares), it may treat as its own profits available for distribution to its shareholders, dividends received out of pre-acquisition distributable reserves of any one but (except with the consent of the Court in the circumstances described in (h) below) only

one of those companies; it should be entitled to exercise this right only in the circumstances and subject to the conditions indicated in paragraphs 346 and 347, section 56 being amended accordingly;

(h) to meet any exceptional cases of hardship which may arise, the Court should have power at any time to permit any company, which has acquired 90 per cent. or more of the equity share capital of one or more other companies, to treat as its own profits available for distribution to its shareholders all or part of any dividend received by it out of pre-acquisition distributable reserves of the acquired companies. The procedure and the conditions upon which the Court should exercise its jurisdiction should be the same as on a reduction of capital under sections 66 to 69;

(i) provision for depreciation, replacement or diminution of value of wasting assets should be obligatory. Exception should be made for companies, incorporated before publication of our Report, which have adopted, or indicated their intention of adopting, a practice of making no such provision for wasting assets.

#### **Exemption for Unquoted Companies**

351. Earlier in this Report we have recommended that all limited companies should in future be required to file accounts for public inspection with the Registrar of Companies. Since members of all companies are already entitled to accounts and companies in which the general public invest are already required to publish their accounts, the principal object of our earlier recommendation was to provide creditors and prospective creditors of limited companies with adequate information from which to judge their credit status. We recognised, however, that some information required in the accounts, while of interest to the members, was not of prime importance to creditors, and that its public disclosure by some small companies might be embarrassing to them; we had in mind particularly the requirement to disclose directors' emoluments. To meet this, in our opinion, well-founded objection to general disclosure we would give a limited exemption to companies whose securities have been neither

quoted nor offered to the public and which are not subsidiaries of companies whose securities have been quoted or offered to the public. While requiring such companies to circulate *full* accounts to their members and their debenture holders, we would permit them to exclude from accounts filed with the Registrar of Companies:

(i) the information about directors' emoluments now required by section 196;

(ii) the details of turnover and rents receivable and payable which we suggest below should in future be required by the Eighth Schedule.

We do not think that this limited exemption will materially reduce the value to creditors of the filed accounts of such companies. Members of such companies will get full accounts like the members of any other company. Prospective investors will, it is true, be unable to obtain

from the public files quite as much information about these as other companies but we have limited the scope of the exemption to companies in which the general investing public will not be interested.

352. We recommend that companies whose securities have been neither quoted nor offered to the public and which are not subsidiaries of companies whose securities have been quoted or offered to the public should be permitted to withhold from accounts filed with the Registrar of Companies (but not from accounts circulated to their members and debenture holders):

(i) the information now required by section 396 about the directors' emoluments;

(ii) the details of turnover and rents receivable and payable which, we recommend in paragraph 397 below, should in future be required by the Eighth Schedule.

#### **Balance Sheet: (1) Fixed Assets**

##### *Valuation*

353. Paragraph 4 of the Eighth Schedule requires the balance sheet to distinguish between fixed and current assets and the method of arriving at the amount of any fixed asset must be shown. Directors are free to show fixed assets at an amount calculated at cost less depreciation or at a valuation less depreciation; in either case the amount written off for depreciation must be shown separately. Where the amount of a fixed asset purchased many years ago is shown at cost less depreciation, the net figure shown in the balance sheet will often bear no relation to the current value of the asset estimated on any reasonable basis. This has probably given rise to more criticism than any other single feature of the accountancy provisions of the Act, and many proposals have been made for amending the law in this respect. Some witnesses, who think that a balance sheet should state the

current value of the company's assets, have gone so far as to propose that directors should be required annually to revalue the fixed assets and show the result of the latest revaluation in the balance sheet. This proposal is based on a conception of the function of a balance sheet which, as we have indicated at paragraph 333, we think mistaken. Valuations must obviously be largely a matter of opinion. They vary according to the basis on which they are made, and the question of what is the appropriate basis will depend on the purpose for which the valuation is made. To require a periodical revaluation of fixed assets would, in our opinion, be to impose a most onerous duty on companies and require them to give information which we think would often be worthless and misleading.

354. It seems to be generally agreed by witnesses that the proper value of fixed assets is in most cases their value as an integral part of the undertaking in which they are employed. This is true, above all where assets are "specific" to a particular business, that is to say, where they are suitable only for the particular purpose for which they are being employed. Thus the value of the fixed assets and of the goodwill of the business can often best be measured by reference to the figure of earnings; an estimate of what the fixed assets might realise if sold otherwise than as part of a going concern can be a highly theoretical

exercise, resulting in misleading figures, and for the purposes of estimating their value as part of a going concern the profit record is the best guide. In most cases, therefore, the investor has all he requires for his purpose if the profits are fairly stated. Where the cost of replacing assets is likely to be greatly in excess of the amounts provided for depreciation on the historical cost basis, an estimate is sometimes made of the replacement cost (less depreciation) of the assets. This, too, can be misleading to the shareholder especially in cases where, as a result of technological improvements, it is improbable that like will be replaced by like. In any case it would give no reliable indication of the price that might be realised in a sale other than as part of the business as a going concern. It is, however, important that companies should maintain their operating capacity and that shareholders should be kept informed of the financial policy which is being adopted to ensure this.

355. Witnesses were generally agreed that plant and machinery are usually specific to a particular business; their life is often relatively short compared with land and buildings and any under-valuation is, therefore, soon worked out of the accounts. Moreover, a valuation of plant and machinery is a formidable undertaking in most works and even the staunchest advocates of valuation showed little enthusiasm for applying their principles to plant and machinery, except plant which has a long life or is inseparable from the buildings. It is, therefore, only in respect of land and buildings which are "non-specific", that is to say, are suitable for uses other than those to which the company has put them, that serious criticism arises. Where for example a site owned by a company is capable of development for some other purpose, the discrepancy between its cost and its current realisable value may be very great: and many witnesses have complained that accounts which merely state such sites at cost are seriously misleading to the shareholders.

356. We think this is a valid criticism of the present statutory requirements but we have not found it easy to meet it. The difficulty is to define, in a manner which will be appropriate in all circumstances, not only the kind of assets to which any new requirements should apply but also what those requirements should be.

357. First, it is difficult to define "non-specific asses" and for the reasons we have already given we think it would be unreasonable to put all companies to the expense and difficulty of providing information about the current estimated market value of all their fixed assets. A large steel works in an industrial area, which is clearly unsuitable for commercial or residential development, will not ordinarily be useful for any other purpose than that to which it is presently being put. On the other hand, a shop in the middle of a town may be turned to a wide variety of other uses (as it stands or after rebuilding) providing the necessary planning permission can be obtained. The steel works is a specific asset and any estimate of the current value of its land and buildings is of little significance to the shareholders. The shop, on the other hand, is a non-specific asset whose current market value may be of great relevance to the shareholders and may often be capable of fairly precise assessment. Between the two extreme examples

lie a wide variety of types of assets which, according to the particular circumstances at any time, may reasonably be considered as specific or non-specific or somewhere in between.

358. Secondly, circumstances vary so greatly between one company and another' that we do not think it would be possible to prescribe in detail the information which should be given by every company about the current value of non-specific assets (if these could be defined). The directors of some companies no doubt already make periodical valuations of the company's land and buildings and pass this information on to their shareholders: but the intervals between valuations are no doubt varied to suit the particular circumstances of each company. The directors of many other companies may reasonably consider that such periodical opinions as to current values are of no real significance to the shareholders and not worth the expense of a professional valuation. Valuations are matters of personal opinion and they can quickly be out-dated: for example, the value of individual properties often depends upon whether or not planning permission for particular purposes will be granted. The directors' duty is to manage the company's business rather than try to find buyers for the company's assets and we think it would be unreasonable to impose upon them the legal responsibility to make periodical investigations even if these were of significance to the shareholders - into the possible alternative uses to which the company's land and buildings might be put and what the site value might be worth in various alternative, hypothetical situations. In small businesses some indication of the current value of their properties (as compared with the book value) might be given by listing short particulars of the properties; in large businesses that would be altogether too cumbersome. In some cases information about land and buildings might be given by showing them at cost less depreciation and grouping them according to the period during which they were acquired, but in many cases continual additions and improvements to the land and buildings since acquisition might make this meaningless. We do not think it would be possible to specify the cases in which a valuation should be made nor what other means of indicating the position to the shareholder should be adopted where a valuation was not required.

359. In any event, we doubt whether an indication that the estimated current value of a company's fixed assets is greater

- or less - than their book value would alone be always sufficient. A company operating from a site capable of development may be able to carry on its business equally profitably from a cheaper site elsewhere - or it may not - and a mere statement of the estimated current market value of its present site without any indication of the effects of its disposal on the company's business would not be very informative to shareholders.

360. We have therefore come to the conclusion that it would be impracticable to deal with this problem by adding to the statutory requirements in the Eighth Schedule. However we think that it is a matter upon which the directors might reasonably be expected to comment in their annual report to the shareholders. Accordingly, where the current market value of a company's fixed assets is substantially different from their book value, and

the directors consider that this difference is of real significance to the shareholders - for example because some or all of the assets could be profitably sold for use for another purpose we think that the directors should be required to indicate this fact in some way in their annual report (if they have not done so in the accounts by, for example, a revaluation), with such comment as they consider necessary to inform the shareholders of the position. We recommend accordingly in paragraph 122 (a) (v).

361. We recognise that there are circumstances in which directors may legitimately revalue fixed assets and show the results in the balance sheet and indeed this is clearly recognised by paragraph 5 of the Eighth Schedule. We understand that the Securities and Exchange Commission of the United States have hitherto refused to sanction this practice. The practice is capable of abuse and we think that where it is adopted the safeguards indicated in our recommendation at paragraph 369 (a) should be imposed and depreciation charges should be based on the revalued figures as recommended in paragraph 397 (a) below. The revaluation of fixed assets frequently results in a higher depreciation charge and consequently a lower profit. It has been suggested to us, therefore, that, in some circumstances, a revaluation of fixed assets can be detrimental to the interests of preference shareholders. We agree that this is a factor which directors should take into account when deciding upon a revaluation but we do not think this is a matter for regulation by statute.

362. Paragraph 2 of the Eighth Schedule requires *inter alia* the assets to be summarised with such particulars as are necessary to disclose their general nature. In our view, the balance sheet should show separately freeholds (in Scotland, feus) and leaseholds, distinguishing also between long and short leases. We have received evidence to the effect that property companies should be required to give details of their properties by type and size, and to distinguish in their accounts between profits from rents and from property dealing. We have dealt with the latter point by our recommendation in paragraph 397 (c) that income from rents, when significant, should be shown separately in the profit and loss account. We think that good practice should require the provision of information about properties, although we do not think it should be required by law. It would, in any event, be difficult to define a property company for this purpose. We

therefore look to the appropriate City institutions to encourage its provision.

### *Investments*

363. We have received representations from many quarters that the Eighth Schedule does not require adequate information to be given about the value of trade investments, and that the figures given about them in the balance sheet are often seriously misleading. The term "trade investments" is not defined in the Act, but we understand the expression to cover any investments (other than investments in subsidiary companies) made to further the company's business, including investments in what are generally described as "associated companies" The aggregate amount of the trade investments is required to be shown under a separate heading in the balance sheet and the income from trade investments to be shown separately in the profit and loss account. Being fixed assets, they should

normally be shown at cost less depreciation or at a valuation less depreciation: but they may be shown at their market value (or at the directors' estimate of their value).

364. We agree that these provisions are inadequate and we think that more information should be required to 'be given in relation to trade investments, whether quoted or not, and also to other unquoted investments (not being investments in subsidiary companies with which we deal separately below). Indeed we see no good purpose in preserving the existing distinction in the Eighth Schedule between trade and other investments though the distinction between investments which are fixed and those which are current assets should be retained. There should be a general requirement that the aggregate market value of all quoted investments (other than investments in subsidiary companies) should be given either in the balance sheet or in a note. Where the investments are not quoted, the directors should be given a choice between stating their own estimate of the aggregate value and, if the investments consist of equity shares, giving the additional information specified in our recommendations at paragraph 369 (f) below. The additional information there specified relates to dividends received from, and profits made by, the companies in which the investments are held. In some circumstances it will be necessary for this information to be supplemented by further information or explanations if the accounts are to give a true and fair view. Some of the companies concerned may have made losses, their financial years may end at different times, their latest accounts may not always be available. We do not think it is practicable to devise in terms applicable to all cases statutory rules which will prescribe the necessary explanations and additional information and define the circumstances in which they will be required. It must be left to the directors and auditors to decide when and what further information and explanations are necessary in such cases to give a true and fair view.

365. It has been suggested that the appropriate proportion of the net book value of assets of companies in which there are trade investments should also be shown in the balance sheet of the "holding" company: we think that, for many companies, this would serve no useful purpose, and it might well be misleading, since the disposal of those assets cannot normally be controlled by the "holding" company. It has also been suggested that investment trusts should be required to publish

in their accounts either a list of their principal investments or a summary, by industry or geographical area, of all their investments. Many investment Trusts, of course, already give such information and we think its provision ought to be regarded as standard good practice. We do not however think it should be required by law.

*Realisation of investments and treatment of profits*

366. The evidence we have received indicates some difference of opinion about the proper method of calculation and the treatment of profits made on a realisation of investments. As a matter of orthodox accountancy only the cost of the investment realised should be deducted upon realisation, any profits being treated as reserves except to the extent that they have been utilised to meet losses, or otherwise used for some

appropriate purpose. The practice followed after consultation with the Board of Trade by certain investment trust companies, however, is to use any profits on a realisation to write down the book value of the remaining investments. This practice appears to us to be consistent with the provisions of paragraph 5 (2) (c) of the Eighth Schedule which exempts investments from the general requirement to show fixed assets at cost less depreciation, provided the market (or estimated) value of such investments is given. We see no sufficient reason for altering this practice and if the Eighth Schedule does not make it clearly permissible, it should be amended accordingly.

#### *Capital expenditure*

367. The Eighth Schedule requires the balance sheet to disclose the amount, or estimated amount, if it is material, of contracts for capital expenditure so far as not provided for. It has been suggested that it should also be required to show capital expenditure (where it is material) approved by the board of directors but not covered by contracts at the date of the balance sheet and to reveal changes in the amount of fixed assets during the year by showing the value of additions separately from plant sold and scrapped, We agree with both these suggestions.

#### *Distinction between fixed and current assets*

368. Paragraph 4 (2) of the Eighth Schedule requires that fixed assets should be distinguished from current assets. This is not always practicable and in some cases the classification of an asset under either of these headings might be misleading, for example, a balance due to a holding company on current account with a subsidiary or a debt owing for goods sold on extended credit. We think that the Schedule should require assets of this sort to be described separately from either "fixed" or "current" assets and that their nature should be clearly stated.

369. **We recommend that:**

(a) if any fixed assets are shown at a valuation in the balance sheet, it should be stated what assets were revalued, when they were revalued and, in the case of the balance sheet in which the revalued figure first appears, by whom, and on what basis. Where, however, a large number of assets have been revalued on many different bases, and the directors consider that the above statement would be unduly cumbersome, the balance sheet should contain an intelligible summary;

(b) the balance sheet should show separately (i) leaseholds, distinguishing short from long leases, and (ii) freeholds (fens in Scotland); a lease with less than fifty years to run from the balance sheet date should be treated as a short lease;

(c) the existing distinction in the balance sheet between trade and other investments should be abandoned but the distinction between investments held as fixed assets and those held as current assets should be maintained;

(d) the aggregate market value should be stated of all investment (other than investments in subsidiaries) in respect of which a

quotation has been granted on a recognised stock exchange in Great Britain or on any stock exchange of repute elsewhere;

(e) where the investments are not quoted investments the balance sheet should either (i) show the directors' estimate of their aggregate value or (it) in respect of equity share capital (as defined in section 154 (5)) give the additional information specified in sub-paragraph (f) below (the directors should be free to estimate the value of part of the company's unquoted investments and give the information in (f) about the remainder);

(f) in relation to investments consisting of equity 'share capital the additional information mentioned in sub-paragraph (e) above should consist of:

(i) the aggregate dividends and other income brought into account from the investments during the company's financial year;

(ii) the amount of the company's share of the aggregate profits, both before and after taxation, of the companies in which the shares are held for the financial periods for which the latter Issued accounts during the company's financial year;

(iii) the amount of the company's share of the aggregate undistributed profit, after taxation charged in their accounts, of the companies in which shares are held since the date of acquisition;

(iv) explanation of how losses incurred by such companies have been dealt with in the "holding" company's accounts;

(g) paragraph 5 of the Eighth Schedule should make it clear that a company may use any profits on realisation of any of its investments to write down the book value of the remaining

investments, provided the accounts also disclose the market value of investments (or give the alternative information proposed in sub-paragraphs (e-f) where there is no ascertainable market value);

(h) the balance sheet should show in addition to capital expenditure for which contracts have been placed, the estimated amount of any capital expenditure (where material) which has been authorised by the board of directors but for which contracts have not yet been placed;

(i) the balance sheet should show separately the amounts of additions to and deductions from fixed assets during the year;

(j) assets which cannot truly and fairly be described as either "fixed" or "current" should be shown separately and their nature clearly stated.

#### Balance Sheet: (2) Other Matters

##### *Stocks*

370. The treatment of stock-in-trade and work-in-progress (subsequently referred to as stocks) in annual accounts has, by reason of its importance and difficulty, been much discussed by professional accountants in recent years and in November 1960 the Institute of Chartered Accountants in

England and Wales issued a revised recommendation on the subject. The current opinion is well summarised in the following passage from the memorandum submitted to us by the Institute:

"In most businesses the amount carried forward for stock-in-trade and work in progress as on the balance sheet date has a material bearing on the amount of profit or loss for the period ended on that date. The basis normally used to determine the amount is cost less any part thereof which properly needs to be written off at the balance sheet date. There are however various methods of computing cost and alternative methods of arriving at the amount, if any, to be written off and there are various special bases which are regarded as appropriate in some businesses. Circumstances vary so widely that no one basis is suitable for all types of business nor even for all undertakings within a particular trade or industry.

It would therefore be undesirable to attempt to lay down by statute any rules governing the computation of the amount to be carried forward for stock-in-trade and work in progress. Nevertheless the overriding consideration is that the accounts should give a true and fair view and it is therefore important that the basis adopted should be used consistently from period to period and should be appropriate to the nature and circumstances of the business and that the accounts should disclose adequate information ..."

We agree with these views. It must, however, be recognised that the choice of a particular basis for the statement of stock may result in the stock being included in the accounts at an amount much lower or higher than if another basis had been used. The bases will reduce or increase accordingly the profit taken to date and will cause differences in the trend of profits disclosed from year to year. We think, therefore, that shareholders ought to be concisely but adequately informed as to the basis used. Any departure from the basis previously in use and the effect of any such change should also be brought to the notice of shareholders if the effect is material. Where a company employs many different bases of computation, to require an explanation of each of them to be given would result in the provision of a mass of detail which would be of little or no value to the members. In such a case

the directors should be required to provide as intelligible a summary as they can.

*Issued capital, reserves, provisions and liabilities*

371. Paragraph 2 (a) of the Eighth Schedule requires the balance sheet to show any part of the issued capital that consists of redeemable preference shares and the earliest date on which the company has power to redeem those shares. We think this requirement should be extended to include the latest date for redemption, the amount of the premium on redemption (if any) and whether redemption is at the option of the company or is obligatory.

372. It has been suggested that the definitions of "capital reserve" and "revenue reserves" in Part IV of the Eighth Schedule are unsatisfactory and that "capital reserves" should be redefined to mean only those reserves which may not lawfully be distributed. We have some sympathy with this view, but as we have indicated in paragraph 335 above we do not think it is practicable to formulate statutory provisions for determining what are profits available for distribution. There may

be cases where directors will be uncertain whether a reserve is lawfully arguable for dividends or not and in view of this possible uncertainty we do not think it would be wise to impose upon them a statutory obligation to distinguish between reserves which are, and those which are not, distributable. In these circumstances we think that the existing requirement in paragraph 6 of the Eighth Schedule) to show separately capital and revenue reserves should be abolished and that company directors and auditors should be left to classify any reserves under headings appropriate to the circumstances in order to show a true and fair view (for example, according to the sources from which they were derived).

373. It has been suggested that the definition of a "provision" in the Eighth Schedule should be amended to make clear that it includes an amount necessarily set aside in accordance with a regularly employed accounting practice in order to meet accruing expenditure such as that on repairs and other maintenance charges but that amounts so set aside should not be required to be shown separately in the profit and loss account. The definition of a provision in paragraph 27 of the Eighth Schedule has, however, proved generally satisfactory and we do not think it should be changed to make its meaning dependent upon accounting practice which can vary from time to time.

374. Paragraph 8 (1)(d) of the Eighth Schedule requires the balance sheet to show under a separate heading the aggregate amount of bank loans and overdrafts. We think that, in addition, the balance sheet should give more information about long and medium term borrowing and we recommend accordingly in paragraph 380 (f).

#### *Disclosure of companies' shareholdings*

375. Many witnesses have criticised the present Act on the ground that it does not require adequate disclosure by a company of its share-holdings in other companies. We agree with this criticism and think that it should be met by requiring every company to disclose the name of (a) each subsidiary, (b) each company of which it is a registered 10 per cent. shareholder (under our recommendation at paragraph

147). In respect of each of such companies it should also be required to disclose the amount of its holding, the percentage of each class of capital held and the country of incorporation. It should do this in its annual accounts unless the directors consider that this would be inconvenient in which case the information should be disclosed in a statement filed with the Registrar of Companies when the annual accounts are filed. The information should not be required in respect of subsidiaries incorporated outside the United Kingdom if, in the opinion of the directors of the holding company, such disclosure would be harmful to the company or the group to which it belongs. Such a provision, together with the amendments to section 157 (2) which we have recommended in paragraph 122 (a) would, in our view, give the shareholders the means of obtaining considerable information about the affairs of the companies in which their company holds shares.

376. We also think that a subsidiary should disclose the name and country of incorporation of its ultimate holding company in its annual accounts. If it cannot obtain this information it should be required to

say so and to give the name, and country of incorporation of the most senior company known to it in the chain.

377. It has been suggested that group accounts should draw attention to the fact when some of the group profits are retained by foreign subsidiaries and are not readily transferable to the United Kingdom. We think the general obligation to give a true and fair view adequately cover this case and in any event we do not think a specific provision could satisfactorily take account of the variety of different circumstances which might arise in such cases.

378. Paragraph 15 (2) of the Eighth Schedule requires the balance sheet of a holding company to set out separately from all other assets the aggregate amount of its interests in subsidiaries. We think the balance sheet of a subsidiary company should also be required to show separately the aggregate of any shares which it holds in its fellow-subsidiaries and the aggregate amounts owing to and by them.

#### *Unclaimed dividends*

379. Once a company declares a dividend a debt is created owing by the company to the members entitled to participate in that dividend and the period of limitation applicable (12 years in England and Wales and 20 years in Scotland) begins to run from the date the dividend is made payable. It appears, however, that the payment of any unclaimed dividends into a separate account might be held to constitute the company a trustee in respect thereof, in which event the period of limitation would not apply; it also appears that an entry of liability for unclaimed dividends in a balance sheet circulated to members might be a sufficient acknowledgement to start the period of limitation running afresh. We think it unreasonable that companies should be made liable in respect of unclaimed dividends for an indefinite period in this way and that the Act should accordingly be amended.

380. **We recommend that:**

(a) where the amount carried forward for stock is material in relation to either the trading results or the financial position the accounts should be required to indicate concisely the manner in which the amount has been computed;

(b) It should be made clear that paragraph 14 (6) (&) of the Eighth Schedule requires the disclosure of the effect of any change in the basis or method of computing the value of stock, when this is material;

(c) where a company uses many different bases for computing its value of stocks and, in the opinion of the directors, a statement of all the bases used would be of little value to shareholders, the directors should be required to give an intelligible summary;

(d) where a company has issued redeemable preference shares, its balance sheet should disclose whether redemption is at the option of the company or obligatory, the amount of the premium (if any) payable on redemption, and the latest as well as the earliest date for redemption;

(e) the requirement in paragraph 6 of the Eighth Schedule, to show separately capital and revenue reserves, should be abolished;

(f) the balance sheet should be required to show the amount of long and medium term indebtedness separately from other liabilities, together with the dates and terms of repayment and the rates of interest; for this purpose a long or medium term loan should be defined to mean one which the company is not bound to repay within five years from the date to which the balance sheet is made up;

(g) a company should disclose in relation to each of its subsidiaries, its name, its country of incorporation, the amount of the company's holdings and the percentage of each class of the subsidiary's capital held, in the annual accounts or, if this is inconvenient, in a statement filed with the Registrar of Companies when the annual accounts are filed; but there should be an exception in respect of a subsidiary incorporated outside the United Kingdom, if the directors of the holding company consider that the disclosure of the name of any such subsidiary would be harmful to the Interests of the group;

(h) a company should disclose similar information about its holdings in companies in which it is a registered 10 per cent. shareholder under our recommendations at paragraph 147;

(i) every subsidiary company should be required to disclose the name and country of incorporation of its ultimate holding company in its annual accounts; i.e., where company A is a subsidiary of company B which in turn is a subsidiary of company C, company A would disclose company C as its holding company; if the subsidiary cannot obtain this information it should be required to say so and to give the name, and country of incorporation, of the most senior company known to it in the chain;

(j) the accounts of a subsidiary company should disclose the aggregate amount of its holding of shares in fellow-subsidiaries and the aggregate amounts owing to and by them;

(k) there should be added to the Act a provision expressly declaring that the payment of any unclaimed dividends into a separate account shall not constitute the company a trustee in respect thereof and that an entry in a balance sheet of a statement of liability in respect of unclaimed dividends shall not constitute an acknowledgement in writing which would have the effect of starting the period of limitation running afresh.

### **Profit and Loss Account**

#### *Income*

381. Paragraph 12 (1) of the Eighth Schedule requires the profit and loss account to disclose income from investments, distinguishing between trade and other investments. We see little merit in this distinction and we agree with those witnesses who have suggested that it would be more useful if income from quoted investments were distinguished from income from unquoted investments, whether trade or other investments.

This is consistent with our recommendation in paragraph 369 (c) above and we think the Eighth Schedule should be amended accordingly. We also agree that where a substantial part of the income of a company is derived from rents, the amount so received should be shown separately in the profit and loss account.

382. It has been suggested that accounts should show, by geographical area and by industry, how the profits are derived and their relationship to assets employed. In many cases this information would be valuable to shareholders and a number of companies already provide it in some measure. We would welcome an extension of this practice but we do not think it should be imposed by law on every company. The provisions of section 151 (2) give directors considerable latitude in choosing the form in which to present group accounts. By preparing separate sets of consolidated accounts each dealing with a different group of companies, they could in many cases give the required information by geographical area or type of industry. Directors of a large company which carries on highly diversified activities are also free to show the position of each division separately in the company's accounts.

#### *Items of expenditure*

383. We think that the profit and loss account should show separately (i) the rents paid for land and buildings and (ii) the rents paid for plant and machinery. It is becoming increasingly common for companies to sell their freehold properties and take them back on lease from the purchaser and to hire instead of buying machinery and plant. We think the shareholder should be told how much of the company's gross earnings are committed in this way to meet its obligations in respect of rent; these obligations are economically the equivalent of depreciation and interest on debentures and other fixed loans which are already required to be shown separately in the profit and loss account. We also think that the profit and loss account should show, in addition to interest paid on debentures and other fixed loans, interest paid on bank overdrafts and other short term loans.

#### *Taxation*

384. Paragraph 12 (1) (c) of the Eighth Schedule requires foreign taxation to be shown as United Kingdom income tax to the extent of the relief from United Kingdom income tax. This has the effect of requiring overseas tax to be described wrongly as United Kingdom income tax. It also fails to recognise that under present taxation regulations relief from overseas taxation is given first against profits tax. The Institute of Chartered Accountants in England and Wales have proposed changes to paragraph 12 (1) (c) to deal with this and, in paragraph 397 (f) below, we recommend their adoption.

385. Income tax for the fiscal year which commences on 6th April is normally based upon profits of a company for the last financial year ended prior to the commencement of the fiscal year. It follows from this that the legal liability to income tax at the date of the annual accounts does not include the liability which may be expected to arise in respect of profits earned in the period covered by the accounts. If:

however, the income tax provision is limited to the bare legal liability as at the date of the balance sheet, the charge for income tax in the accounts will not be related to the profits for the year but to the profits of an earlier period. This can be misleading and could have serious consequences when profits decline. It has, therefore, become the general practice - subject to exceptions in the case of, for example, newly formed companies - to charge in the profit and loss account for any year the estimated amount of income tax which will be assessed on the profit of that year, with the result that the balance sheet will show in addition to the legal liability the amount set aside for the income tax which will in due course be based on the profits of that financial year. The view has been expressed that sums so set aside for future income tax are, on a strict construction of the definitions of the words "reserve" and "provision" contained in the F. Eighth Schedule, reserves and not provisions. Nevertheless the practice has become established of showing these amounts as separate items under such headings as "future income tax" and not to include them under either reserves or provisions, We suggest that the law should be amended to require that amounts, if any, set aside for this purpose should be shown separately in the balance sheet.

386. There is often a wide difference between the profits calculated in accordance with recognised accounting principles and the profits computed for the purpose of income tax and profits tax. For example, in years when substantial capital expenditure is incurred the allowance for taxation, including initial allowances, may be considerably in excess of the depreciation charged in the accounts. In later years the depreciation on such assets will be greater to a corresponding extent than the amount allowed for taxation. It has, therefore, become common, though not universal, practice to set aside to a tax equalisation account an amount equivalent to tax at the current rates upon the difference between the book amount of [he assets upon which depreciation is charged and the amount of the assets upon which the Inland Revenue allowance is calculated. As in the case of amounts set aside for future income tax, the amounts set aside to tax equalisation account should, in our view, be shown as a separate item distinct from either reserves or provisions.

387. The present uncertainty about the position in law of an amount set aside for future tax or tax equalisation has caused

embarrassment upon the acquisition of a subsidiary since there is doubt whether after the acquisition amounts so provided are reserves of profits or provisions. It should be made clear that, unless the contract of acquisition otherwise specifies, the acquiring company for the purpose of determining the amount of the pro - and post - acquisition profits of the acquired company should treat these amounts as provisions and not reserves of that company.

388. Further we think that while it should not be obligatory to set aside sums for future tax or tax equalisation, nevertheless sums that are set aside for either of these purposes should not be available for distribution by way of dividend except to the extent that they are no longer necessary for the purpose for which they were set aside. If they are used for any other purpose the extent to which they are so used should be disclosed, If no amount, or an inadequate amount, is set aside for future income tax or for tax equalisation, an explanation should be given.

389. Investment allowances which are granted as a deduction from taxable profits are, like initial allowances, computed by reference to capital expenditure during the year but, unlike initial allowances, do not affect the tax liability in the future. The incidence of investment allowances can materially affect the net profit after tax for the year. The net profit may also be affected if tax losses, including balances of unused investment and initial and other capital allowances, are carried forward from past years with the result that for a period the company may be relieved of any tax liability even though current profits are being earned. There are many other ways in which differences may arise between actual and taxable profits of which the foregoing are perhaps the most important. We do not think that it would be possible to lay down detailed rules prescribing how these matters should be dealt with in all cases, especially as the law relating to taxation is frequently changed. However we think there should be a general requirement to refer to significant tax matters rather than leave it to the general duty to give a true and fair view and we recommend accordingly in paragraph 397 (j) below.

390. Depreciation of some assets, for example commercial buildings, is not an allowable deduction for tax purposes, although depreciation may have to be provided in the accounts, particularly in respect of the cost of leasehold property which must be amortised over its life. A somewhat similar position arises where assets, whose depreciation is an allowable deduction for tax, have been revalued. Depreciation will have to be provided in the accounts on the new, increased value; but the Inland Revenue deductions for tax will be computed by reference to the original cost. These cases are different from those which are referred to in paragraph 389 and provided for by our recommendation in paragraph 397 (j) because they do not affect tax liability. We do not propose that any specific provision should be made to deal with them. Nevertheless, there may be cases where, in order to give a true and fair view, information should be given in the accounts as to the extent to which depreciation or amortisation will have to be provided in the future without relief from tax.

*Auditors' remuneration*

391. Paragraph 13 of the Eighth Schedule requires the accounts to show separately the auditors' remuneration, if this is not fixed by the company in general meeting. This provision is reasonable enough on the assumption that shareholders attend company general meetings but in modern conditions we think the auditors' remuneration should always be shown as separate item in the accounts. This would incidentally meet the criticism that the figure required to be shown by paragraphs 13 and 17 of the Eighth Schedule for auditors' remuneration in the consolidated profit and loan account of a group may be only part of the remuneration paid for the audit of the group's accounts and should be the total remuneration.

*Profits of the year*

392. Section 149 (I) requires every profit and loss account of a company to "give a true and fair view of the profit or loss of the company for the financial year." The Institute of Chartered Accountants in England and Wales have pointed out that opinions may legitimately vary as to what may be shown as the profits of a financial year and in particular as to how items

relating to the results of the operations of past years should be shown. We think that it should be made clear that exceptional credits or charges, in respect of earlier years, should be required to be passed through the profit and loss account but need not necessarily be included in the amount shown as profit or loss for the year.

*Turnover, summary of past results, interim reports*

393. Many witnesses have suggested that company accounts should be required to show turnover. A company's turnover, considered in conjunction with other information, can provide investors with a useful guide to the progress of the business. It is true that the total turnover for one year of a company, or group of companies, engaged in many different activities might not be of any real significance, but the trend of such figures over a period of years, even of a company or group of that sort, could be of considerable value to an informed investor. We, therefore, believe that the time has come where the Act should require disclosure of turnover.

394. We recognise that such a requirement will give rise to difficulties. First, it has been put to us that disclosure might seriously harm some companies, in particular companies which manufacture or sell a single product. Such companies, it is claimed, would in effect be required to disclose their margin of profit per unit whilst their competitors, if they were manufacturing or selling a variety of products, would not disclose the margin of profit on any one of them. Although American witnesses who gave evidence before us were unanimous in their opinion that disclosure of turnover in the United States, where it has for some years been a statutory obligation in respect of stocks listed on a stock exchange, had not caused material harm, we think that there should be exemption here for those companies whose directors are satisfied that disclosure would be harmful to the companies and make a statement to that effect in the accounts. Secondly, there are companies, such as banks, finance houses and discount companies, for which turnover figures provide no useful information. For such cases, too, we think there should be an exemption which might be invoked by the directors with an explanation to that effect in the accounts. The grounds for this exemption should be narrowly drawn so that it would not be open in the ordinary way to industrial and commercial

companies or groups of such companies: as we have explained above we do not agree with those who have submitted that the total turnover of a group engaged in many different activities is a meaningless or worthless figure. Thirdly, there is the problem of definition. Generally speaking we think that turnover might be described as the total amount receivable by a company in the ordinary course of its business for goods sold or supplied by it as a principal and for services provided by it. This definition does, however, leave a number of matters undecided, for example, whether group turnover should include inter-group transactions; whether excise duty and purchase tax should be included: whether discounts, returns and allowances should be deducted. We do not think that the new Act should attempt to give a precise definition of turnover covering these and, no doubt, numerous other points of detail. Each company should be free to state the figure, which in the opinion of the directors, gives a true and fair view of its turnover, and an explanation of the basis adopted in the computation should be given in the first accounts after

the requirement is enacted: thereafter, if any change is made in the basis of computation, it too should be explained in the annual accounts in which the change is made. We hope that, in due course, a standard method of computation will be evolved by the organisations concerned, but meanwhile we think that figures provided in accordance with the suggestions we have made above would be valuable and should be required by law to be given.

395. We also think that it would be useful if annual accounts were required to give in summary form a statement for each of the previous five years of (a) issued share capital and reserves, (b) net profits before and after taxation, (c) dividends, and (d) turnover (for companies not exempted from disclosing this). When a change is made in the basis of computation of any of these items and the effect is material, the fact that such a change has been made should be disclosed and its effect explained. We do not think this should present any serious difficulties and indeed many companies already do it.

396. If the information contained in accounts is to be useful to inventors, it must be reasonably up-to-date. We welcome the practice now followed by many large companies of providing their members with interim reports and accounts, but we do not think it would be reasonable to make this a statutory obligation for every company.

397. **We recommend that:**

**(a) directors should remain free to choose the method of depreciation (reducing balance, straight line, sinking fund) appropriate to the circumstances of their companies. Depreciation should be based on the assets figures shown in the balance sheet (whether at cost or at a valuation) and any amounts set aside for replacements over and above the amount of depreciation so computed should be shown separately. This recommendation does not apply when provision is made for renewal of assets instead of depreciation;**

(b) a company should be required to distinguish in its profit and loss account between income from quoted and unquoted investments instead of being required to distinguish between income from trade and other investments;

\*(c) if a significant part of a company's income is derived from rents, the amount so derived, after deductions for ground rents, rates and other outgoings, should be shown separately in the profit and loss account;

\*(d) the profit and loss account should be required to show as separate items, the charges for rents (i) for land and buildings, and (ii) for plant and machinery;

(e) the profit and loss account should be required to show as a separate item, interest on bank overdrafts and other short-term indebtedness. A short-term loan should be defined to mean one which the company is bound to repay within live years of the date to which the balance sheet is made up;

*\* See paragraph 352 which recommends that certain companies should not be required to disclose these items in the accounts which they file with the Registrar of Companies*

(f) paragraph 12 (1) (c) of the Eighth Schedule should be amended to require the profit and loss account to show

(i) the amount, before double-tax relief, of United Kingdom tax, distinguishing profits tax from income tax;

(ii) the amount of double-tax relief; and

(iii) the amount of overseas tax, if any;

(g) the Eighth Schedule should provide that amounts set aside to meet future tax liability or for tax equalisation should be shown in the balance sheet as separate items, distinct from either reserves or provisions; if no such amounts or inadequate amounts are set aside for either of these purposes an explanation should be given;

(h) it should be made clear that, upon the acquisition of a subsidiary, amounts set aside by it for future tax or tax equalisation should be treated by the acquiring company as provisions made by the acquired company unless the contract of acquisition otherwise specifies;

(i) sums set aside to meet future tax liability or for tax equalisation should not be used for other purposes except when they are no longer required for the purposes for which they were originally set aside. If used for other purposes, the extent of such use should be disclosed;

(j) the Eighth Schedule should be amended to require the annual accounts of a company to disclose any special circumstances significantly affecting its current and future liability to tax, except so far as they are covered by (g) above;

(k) paragraph 13 of the Eighth Schedule should be amended to require the auditors' remuneration to be shown under a separate heading in the accounts whether or not such remuneration is fixed by the company in general meeting;

(l) the Eighth Schedule should require that any exceptional credits or charges, arising from previous years, should be passed through the profit and loss account;

\*(m) annual accounts should be required to disclose turnover. Group accounts should show group turnover. The method of computation should be explained in the first annual accounts after this requirement is enacted and thereafter whenever the method of computation is changed;

(n) there should be exemption from the above requirement for companies whose directors are satisfied that disclosure would be harmful to the companies and make a statement to that effect to the accounts;

(o) there should also be a narrowly drawn exemption for companies such as banks and discount companies in respect of which publication of such figures would not be useful. If this is invoked

*\* See footnote on page 153.*

by directors of a company they should make a statement to that effect in the accounts;

(p) the annual accounts should be required to include a summary, covering the five financial years ending with the date of the balance sheet, of

(i) issued share capital and reserves, including balance on profit and loss account;

(ii) the annual profits before and after tax;

(iii) the amount of the annual dividend

(iv) turnover (with exception for years when disclosure was, or is not required).

#### **Exemption of Banks, Discount Houses, Insurance and Shipping Companies**

398. Until shortly before the present Act came into force it was common for companies of all classes to conceal the strength of their financial position by creating and maintaining reserves, the existence and size of which were not disclosed in the annual accounts, although after *R. v. Kytsant* the practice of disclosing in the accounts transfers from hidden reserves was generally adopted. The Cohen Committee made a number of recommendations which were designed to ensure that as a general rule, full disclosure should be made in the accounts, and in particular that the size of reserves and transfers to and from reserves should be shown. The Committee however recommended an exception from these requirements for companies which satisfied the Board of Trade that they were banking or discount companies and for insurance companies within the scope of the Insurance Companies Act, for reasons which are contained in paragraph 101 of their report. The Act provides exemptions for these companies and provides for a

similar but less extensive exemption to be enjoyed by companies of a class prescribed by the Board of Trade, the Board being empowered to prescribe such a class where it seems desirable in the national interest. Shipping companies engaged in foreign trade constitute the only class for which the Board of Trade have exercised this power.

### **Banks and Discount Houses**

399. We were informed that, in March 1961, 107 companies were recognised by the Board of Trade as banking or discount companies. They fall into the following categories:- the London Clearing Banks and the Scottish Banks (16), the Accepting Houses (16), the British Overseas Banks (14), Foreign Banks (36), Discount Houses (12), and Miscellaneous (13).

400. The principal exemptions enjoyed by the banks and discount houses are:

(a) they may make undisclosed transfers to and from reserves before arriving at published profits,

(b) they need not show the charge for tax as a deduction from the published profit;

(c) they are not obliged to distinguish in the balance sheet between reserves, provisions and liabilities:

(d) they need not show the market value of their investments;

(e) they are not required to disclose the method adopted to value fixed assets or to show depreciation separately.

Thus, the banks' published profits in any year may be smaller (or larger) than the profits actually earned and inner reserves may be accumulated by using undisclosed transfers from profits to write down the value of investments and to provide contingency reserves which are aggregated with provisions and liabilities in the published accounts and cannot be separately distinguished.

401. The case now advanced for exempting the banks is broadly speaking the case that convinced the Cohen Committee that exemption was necessary. It is that confidence in the stability of the banks is an asset of national importance as lack of confidence may induce depositors both at home and abroad to withdraw their deposits which form the essential working capital of the banking system; that banks are subject to very large fluctuations in the value of their investments and to periodical losses on lendings which can be out of all proportion to the profits of a single year; and that full disclosure of these fluctuations and losses in the annual accounts might well lead to loss of confidence on the part of depositors and the general public. As the Committee of London Clearing Bankers put it to us:

"Full disclosure in the accounts might embarrass the bank in their policy of making large provisions in good years while the spectacle of heavy drafts on those reserves at other times might undermine that unquestioning confidence in the stability of the banks which is acknowledged to be a national asset of the first importance."

In oral evidence to us Sir Oliver Franks summed up the matter thus:

"There is, I think, no question about the size of these relatively sudden movements which can happen to us from time to time. What has to be weighed is that the effect of their disclosure is likely to be, given that they are out of proportion to the annual profitability of the basics. It is fashionable to say nowadays that of course there could not be a run on the banks. If it were really true that there could not be a run of the banks, then what I am saying about the power of rumors of the effect of group psychology do not apply. But I think the Committee will have to be sure that a run on the banks could not happen; and I suppose that it might be rash to say that because it had not happened for a long while therefore it could not happen. This seems to me to be the crux of the issue on this very difficult subject."

402. It does not seem to us that any changes have occurred since the Cohen Committee's Report either to reinforce or weaken this case. There has, however, been a marked change in public opinion. Disclosure of inner reserves has now been the general rule for over a decade and investors and their advisers are insistent on the need for more, and more significant, information to be given to shareholders. In this climate of public opinion it is natural that the exemptions enjoyed by the banks should be regarded by many as an anachronism. The banks base their claim on the national interest and they argue not that disclosure would inevitably weaken confidence in the banking system but that it is impossible to rule out the risk that in some circumstances it might. The critics

reply that in modern conditions the Bank of England and the Government would come to the rescue if a run on the banks seemed likely to develop and that, in any case, the banks, by under-rating the common-sense of the depositors, exaggerate the effect of disclosure. We think there is much force in the critics' reply. We were impressed by the fact that in 1956 four of the London Clearing Banks indicated by notes on their balance sheets (though there was no legal obligation on them to do so) that their investment reserves had been more than exhausted, and that this had no perceptible effect on confidence either at home or abroad. But some of us were equally impressed by the banks' reply that this disclosure did not by any means necessarily indicate the full extent of the losses suffered and that in different circumstances a full disclosure might have had a far more serious effect on public confidence.

403. That the exemptions have certain disadvantages seems to us to be undeniable. Shareholders in banking companies are deprived of information they need in order to judge the value of theft shares, and to exercise intelligent control over the board of directors: and the right to conceal the size of, and transfers to and from, inner reserves can be used to conceal weaknesses as well as strength. These objections, however, serious as they are, leave the main case of the banks untouched.

404. The question that remains is whether the abolition of the exemption will involve an unreasonable risk. The risk is imponderable and in present circumstances no doubt remote, but the Committee is not prepared wholly to discount the possibility of risk if full disclosure were statutorily imposed upon the 'banks, They have, therefore, asked themselves whether the practical objections to the present exemptions allowed to the banks - who have succeeded in maintaining an efficient and stable banking system in this country for very many years - are so strong that the risk should nevertheless be taken. They do not believe that they are, and the majority of the Committee therefore recommend no change in the present statutory provisions. Having reached this conclusion the majority consider that it applies with equal force to the British Overseas Banks and the Accepting Houses, that it is not, therefore, necessary to discuss the additional arguments advanced by them for exemption, and that

the Discount Houses should continue to be treated in this respect in the same manner as the banks.

*Definition of banks*

405. The Act provides, in paragraph 23 (3) of the Eighth Schedule that the expression "banking company" means any company which satisfies the Board of Trade that it ought to be treated for the purposes of the Schedule as a banking company. The Board have informed us that the exercise of this power has caused them much difficulty and have asked us whether it would be possible to define "bank" or "banking business" in terms that would make it unnecessary to vest this power in the Board. We do not think it would be possible. Our impression is that the Board have carried out this duty very well and have succeeded in ensuring that the companies which enjoy these exemptions as banking companies include

all those companies which fall within the recognised conception of a banking company and, generally, exclude those companies which do not. There are one or two cases where we doubt if the companies concerned still carry on the distinctive activities of a bank and we think that the Board might conduct a review of the borderline cases from time to time and when there is a change of control, to ascertain whether the companies concerned are still carrying on a banking business and are controlled by persons of repute, and if necessary use their existing power to withdraw the exemption.

406. Companies incorporated outside Great Britain with an established place of business within Great Britain are required by section 410 to file annual accounts with the Registrar of Companies. Where such companies satisfy the Board of Trade that they ought to be treated as banking companies they are entitled to the same exemptions as banking companies incorporated in Great Britain. We think that foreign banks operating in this country should continue to be treated, in respect of accounts, in the same way as British banks.

407. **We recommend that:**

**\*(a) the existing exemption of banks and discount companies should continue;**

**(b) the Board of Trade should review the companies which have been exempted at regular intervals and when there is a change of control, to ascertain whether the companies concerned are still carrying on a banking business and are controlled by persons of repute.**

### **Insurance Companies**

408. Insurance companies (by which we mean those insurance companies which are registered under the Companies Act, 1948, and are subject to and comply with the provisions of the

Insurance Companies Act, 1958, as respects the preparation and deposit with the Board of Trade of a balance sheet and profit and loss account) enjoy the exemptions accorded to banks and discount houses from the provisions of the Eighth Schedule. They also enjoy certain additional exemptions; these however, do not raise any question of principle since their effect is simply to exempt insurance companies from giving information which is inappropriate or insignificant in view of the nature of their activities. The important exemptions are those they enjoy in common with banks. These were granted on the recommendation of the Cohen Committee and for the same reason. We were informed in March, 1961 that 432 insurance companies were entitled to these exemptions.

409. The position of the insurance companies seems to us to differ considerably from that of the banks. The Insurance Companies Act, 1958, requires them to prepare and deposit with the Board of Trade accounts which in many respects are more informative than the accounts required by the Companies Act; in particular, the information required by the Insurance Companies Act to be disclosed in their revenue accounts is so detailed that it is difficult to see how substantial transfers to and from inner reserves could be made without disclosure. Copies of these accounts

*\* A note dissenting from this recommendation is to be found on page 211.*

are kept in the custody of the Registrar of Companies and are available for public inspection, and any shareholder or policy holder is entitled on application to a copy of the latest accounts so deposited. We are impressed by the argument that the nature of insurance business is so different from that conducted by an industrial or commercial company that the detailed provisions of the Eighth Schedule to the Companies Act are largely inappropriate, and we agree with the view expressed by the British Insurance Association in their supplementary memorandum that "there is a strong case for the statutory control of the contents of the Profit and Loss Account and Balance Sheets of an insurance company being based on the requirements of the Insurance Companies Act, 1958, rather than on those of the Eighth Schedule to the Companies Act, 1948". We think, therefore, that the accounts, required of insurance companies by the Companies Act, should in future be a simplified version of the form now required by the Insurance Companies Act, in particular classification of investments should not be required in the same detail as is required by the latter Act - but should contain in addition certain information at present required of insurance companies by the Eighth Schedule, and more detailed information about their investment income from the various sources. We suggest that the precise form of accounts required by the Companies Act should be worked out by the Board of Trade in consultation with the British Insurance Association and other interested bodies. The accounts in this form should be required to give a true and fair view, subject to the exceptions in respect of the market value of investments and the application of profits and losses on realised assets, to which we refer in the following paragraph. It is inconvenient that the provisions relating to the accounts of insurance companies should be contained partly in one Act and partly in another, and so far as practicable we should like to see the new legislation so drafted that at any rate the detailed accounting requirements could be found in one document; for example, an order made by the Board of Trade under both the Insurance Companies Act and the Companies Act could prescribe the information required in the accounts furnished to the Board of Trade and in the accounts furnished to the shareholders.

410. Under the Insurance Companies Act, 1958, the directors of an insurance company are required to certify that in their opinion the sets are in the aggregate of the value stated in the balance sheet (prepared for the purposes of that Act) less any investment reserves taken into account. The claim of life insurance companies to be exempted from disclosure of the

market value of their securities, when it is in excess of the balance sheet value, is based on the contention that the value of the assets should not be considered in isolation but in relation to the value placed upon the liabilities. In view of the long term nature of the liabilities and the necessity to estimate the reserves required at a balance sheet date the excess of market value over balance sheet value taken alone gives no indication of the ability of these companies to meet their obligations to their policy holders nor of the size of the surplus available for policy holders and shareholders. What matters, they argue, is the future revenue from their investments not their current market value. This future revenue from investments is required in the first place to cover the rate

of interest necessary to meet their contractual obligations - to their policy holders. The balance will be available as bonus to policy holders and dividend to shareholders. We accept that in the case of life companies the market value of their investments is not in itself a matter of major importance to the initiated and could be misleading to the unsophisticated. So far as non-life businesses are concerned, future investment income does not have the same significance as in life business, and we are not much impressed by the argument that disclosure by these companies of the market value of their securities would be misleading. But we understand that about 70 per cent. of non-life insurance business is transacted abroad, and that, in some countries, insurance companies are subjected to political pressures to increase their local investments either by retaining larger funds in particular countries than is necessary for their local business or by transferring assets from the United Kingdom. This in some cases would involve considerable investment risk. Disclosure of the full reserve position by publication of the market value of the securities of non-life companies could reasonably be expected to increase pressures of this sort, and we therefore doubt whether on balance it would be generally in the shareholders' interests. For these reasons we think that insurance companies should continue to be exempted from disclosure of the market value of their investments (provided the market value is above the balance sheet value) and should continue to be able to apply realised profits from sales of investments and other assets to writing down the balance sheet value of the remaining investments.

411. However, as the Institute of Actuaries have pointed out, "the counterpart of information about market value of investments, which may be relevant for a trading company, is, for a life office, information about future income." We consider that, in substitution for information about market values, all insurance companies should in future be required to give additional information in their annual accounts concerning the income received from different classes of assets, such as redeemable fixed interest securities (in groups according to term), irredeemable fixed interest securities, equities and properties.

412. **We recommend that:**

(a) the Eighth Schedule should not, as such, apply to insurance companies;

(b) the accounts required of Insurance companies by the Companies Act should be a simplified and shortened version of the form now required for the balance sheet, profit and loss and revenue accounts by the Insurance Companies Act; there should also be provision for group accounts and for additional information about investment income according to classes of security; the form of these accounts should be worked out by the Board of Trade in consultation with the British Insurance Association and other Interested bodies;

(c) insurance companies should continue to be exempt from disclosing the market value of their investments (provided it is above the balance sheet value), and should continue to be able to apply, without disclosure, the profits from sales of investments and other

assets to writing down The balance sheet value of the remaining Investments mud other assets as the case may be; the detailed classification of Investments prescribed under the Insurance Companies Act should not be required to be included in the balance sheet presented to the company in general meeting and circulated to the shareholders under the Companies Act;

(d) subject to (c), the accounts of insurance companies should be required to give a true and fair view and the Ninth Schedule to the Companies Act should apply to the auditors' report;

(e) if possible the detailed requirements relating to accounts, under the Insurance Companies Act and the Companies Act, should be contained In one document, for example, an order made under the Insurance Companies Act and the Companies Act prescribing both the information required in the accounts furnished to the Board of Trade and the simpler and shorter information required In the accounts furnished to the shareholders.

### Shipping Companies

413. Shipping companies engaged in international trade enjoy exemptions similar in kind to those conferred upon banks and insurance companies and they are thus permitted to conceal their reserves and to conceal the amount of any transfers to and from those reserves from their shareholders. We were informed that in March 1961 about 250 shipping companies enjoyed these exemptions. They claim that these exemptions are essential and that disclosure of the full facts about the size of their inner reserves and their annual profits would cause serious injury to their interests and therefore to the national interest. Unlike the banks and Insurance companies, they do not claim that the facts would cause misunderstanding, their fear is that the facts disclosed would be used to their detriment by their foreign competitors.

414. They have no home market which can be protected, they are subject to ruthless competition, which benefits from Government subsidies, flag discrimination and, in the case of ships sailing under flags of convenience, low taxes, low wages and poor working conditions. As the scales are heavily weighted against them, they say, they must keep their competitors in the dark about the strength of their financial position, otherwise a foreign Government-subsidised shipping line would be able to estimate the cost of a rate war designed to drive their British rivals off the seas. It is equally important, they claim, to be able to publish annual profits after provision for depreciation and transfers to and from reserves, otherwise their rivals would be able to assess the profitability of their business and this might invite damaging competition. This argument applies with particular force to companies engaged in a single line of traffic; it was emphasised by the spokesman of the P. and O. line that those companies of his group which were engaged in trading on particular routes for this reason used and valued the exemptions, although in other cases the group did not take advantage of them. The exemptions are criticised on the ground that shareholders are deprived of knowledge which would enable them to form a fairer view of the value of their

investments, that they prejudice the bargaining position of employees, and that they make it possible to conceal inefficiency of management. We cannot accept the argument advanced by the spokesmen of the shipping companies in oral evidence that shareholders are not prejudiced by the lack of full disclosure. The question is whether they are prejudiced, but whether the prejudice they suffer must be accepted in the national interest. We do not, of course, question the importance to the national interest of a strong shipping industry, nor have we any reason to doubt that British shipping companies often have to meet unfair competition. We cannot believe, however, that the right to conceal their reserves and their annual results has any real relevance to their problem. If a Government-subsidised foreign line proposed to wage an unrestricted rate war against a British line, we do not believe they would be inhibited by uncertainty about the size of the British company's reserves; a representative of the Council of British Shipping agreed that the extent of the company's liquid assets, which is disclosed, is of more importance in this connexion than the extent of reserves which may or may not be matched by liquid assets. And it seems to us improbable that a foreign company could not estimate fairly closely the profitability of a particular line of traffic without access to detailed accounts of another company.

415. The shipping companies have based their case on the national interest. Their argument, however, is that disclosure would harm the national interest by harming the commercial interests of the shipping companies. So far as their case rests on these commercial grounds, and the case put before us rests only on these grounds, we do not think it has been established. There may be other reasons, which we are not competent to judge, for saying that disclosure would not be in the national interest but on the case presented to us we think the exemptions would be withdrawn.

416. We recommend, on the case presented to us, that the Board of Trade should revoke the Companies (Shipping Companies Exemption) Order, 1948.

#### **Exempting Power**

417. We were invited to consider not only the exemptions enjoyed by the shipping companies but the general power under which those exemptions were granted by the Board of Trade (see paragraph 25 of the Eighth Schedule to the Act). In our view it is reasonable that there should be such a power. It is impossible to rule out the possibility that cases may arise in which the publication of reserves would be misleading or otherwise undesirable and we think it right that the Board of Trade should be empowered to deal with them.

**418. We recommend that the provisions of paragraph 25 of the Eighth Schedule should be retained.**

### **Miscellaneous Provisions**

419. The duty to file accounts with the Registrar is imposed by section 127, which provides that there shall be annexed to the annual return a written copy of "every balance sheet laid before the company

in general meeting during the period to which the return relates (including every document required by law to be annexed to the balance sheet)." The usual practice is to lay accounts before the company at the annual general meeting, but this is not obligatory. If the directors postpone laying accounts to a meeting held after the annual general meeting the latest accounts in the custody of the Registrar of Companies can (quite lawfully) become seriously out of date. Moreover, since the auditors' term of office runs from one annual general meeting to the next, the directors, by procuring the removal of the auditors at the annual general meeting and postponing the laying of accounts until later, can prevent the auditors from completing their duties. These anomalies would be removed if the Act provided that accounts should be laid at the annual general meeting instead of requiring that they should be laid at a general meeting. We recognise, however, that some companies, through no fault of their own, may be unable to comply with this requirement. We have recommended elsewhere that the Board of Trade should be empowered to authority companies to postpone their annual general meetings when circumstances justify this: we think that the Board should also be empowered to relieve companies, subject to such conditions as they consider necessary, from the requirement to lay accounts at an annual general meeting.

420. Section 147 requires the company to keep proper "books of account. "We think this should be modified, if necessary, to permit companies to take advantage of modern methods of making records.

421. The obligation to "keep" proper books of account was obviously meant to cover both the making and the preservation of records. We think the Act should require such records to be preserved for a period of five years.

422. The legal personal representatives of a deceased shareholder have no statutory right to receive copies of the accounts unless their names have been entered on the register of members. We appreciate that this is part of a wider problem, but in our view the Act should be amended to provide that the personal representatives of a deceased member should be entitled, as such, upon request, to receive copies of the company's annual accounts.

423. We recommend that:

(a) company accounts should be required to be paid before the company at the annual general meeting. However, the Board of Trade should be empowered to relieve companies of this obligation subject to such conditions as the Board might consider necessary to impose;

(b) the Act should be amended, if necessary, to permit companies to use modern accounting machinery to keep their accounts;

(c) section 147 of the Act should be modified to require the records made thereunder to be preserved for a period of five years from the date they are made;

(d) the legal personal representatives of a deceased shareholder would be entitled, upon request, to receive copies of the company's accounts.

## CHAPTER XI

### AUDITORS

#### *Qualifications*

424. Subsection (1) of section 161 provides that a person shall not be qualified for appointment as auditor of a company unless he is a member of a body of accountants established in the United Kingdom and recognised by the Board of Trade, or is authorised by the Board of Trade to be so appointed.

Subsection (2) expressly disqualifies any officer or servant of a company and any person who is the partner of or in the employment of any officer or servant of the company. Apart from the disqualification of an officer or servant, neither of these provisions apply in relation to exempt private companies. We have already recommended that the provisions relating to exempt private companies should be repealed. If our recommendations were accepted without further qualification the result would be that a number of persons now employed as auditors of private companies would be deprived of their livelihood. To deal with this sort of case we would empower the Board of Trade to authorise any person who can satisfy them that, at the time of the publication of this Report, he was mainly occupied in private practice as an accountant and was employed as the auditor of an exempt private company to be appointed auditor of a company, provided that none of its securities had been quoted or offered to the public and that it was not the subsidiary of a company whose shares had been so quoted or so offered. The Board should also have power to revoke such authorisation.

425. Another result of the unqualified repeal of the provisions relating to exempt private companies would be that in no case would it be possible for the partner of a director or other officer or servant of the company to be appointed auditor. Small companies sometimes find it useful to have a professional accountant on the board of directors and the most suitable may be a member of the firm who are acting as auditors of the company. In principle, however, we think that the partner of a director, officer or servant of the company should be prohibited from being appointed auditor of any

company and would make no general exception to this prohibition. But if the immediate application of an unqualified prohibition is likely to cause practical difficulties in particular cases, we hope that suitable transitional provisions can be designed to deal with them.

426. Subsection (1) of section 161 distinguishes between (a) the persons who are qualified to be appointed auditors of a company by virtue of their professional status, and (b) those who are qualified by virtue of an individual authorisation given by the Board of Trade. One of the grounds upon which the Board may give such an authorisation is that the person has similar qualifications to those of a member of a recognised professional body established in the United Kingdom, obtained outside the United

Kingdom; the other grounds are related to the experience of a person who is not professionally qualified. It has been represented to us that these provisions are unhappily expressed in that they group members of professional bodies established abroad under head (b) of the subsection with persons who lack professional qualifications. We agree with this criticism and suggest that the subsection should be so amended that persons with foreign professional qualifications are dealt with under the same head as members of recognised bodies established in the United Kingdom.

### *Appointment and removal*

427. Section 159 lays down the general rule that every company shall at each annual general meeting appoint an auditor or auditors to hold office "from the conclusion of that, until the conclusion of the next, annual general meeting". By virtue of subsection (2), however, an express resolution is not necessary and an auditor is automatically reappointed unless he is not qualified for re-appointment or his appointment is expressly or impliedly terminated or he has given the company written notice that he is unwilling to be re-appointed. This can give rise to difficulties when auditors are appointed in the name of a firm. The appointment of an English firm to be auditors of a company is merely the appointment of those individuals who, at the time of the appointment, are members of the firm and are qualified for appointment as auditors. We doubt if this is always understood: companies may assume that a firm continues to be their auditors by virtue of section 159 (2) when, in fact, some or even all of the present members of the firm have not been duly appointed. We think the Act should be amended in two respects. In the first place, section 159 (2) should be repealed and every company required to pass a resolution at each annual general meeting appointing or reappointing an auditor. Secondly, the appointment of an English firm should be deemed to be the appointment of all the duly qualified individuals who are from time to time members of the firm during the period of appointment. It should, however, be provided that the appointment will lapse and a casual vacancy occur if (a) more than half of the individuals who were members of the firm at the time of appointment or re-appointment cease to be members or (b) the number of individuals who have become members of the firm since the time of appointment or re-appointment (and are still members) exceeds the number of those who were originally appointed or

re-appointed and remain members of the firm, The members of the firm should be required to notify the company of the facts creating such casual vacancy. Substantially similar provisions should apply in the case of a Scottish firm, which unlike an English firm is a separate legal entity; i.e. if a change in the partnership of a firm occurs the successor firm should automatically continue as auditors until the next annual meeting, unless the change in the partnership is of the kind mentioned in (a) or (b) above, in which case there should be a casual vacancy. The provisions of section 161 (4) should continue to apply.

428. It has been suggested, and we agree with the suggestion, that the Act should expressly provide that where it is intended to appoint a person in the place of a retiring auditor a copy of the necessary resolution should be sent not only to the retiring auditor as is now required by section 160, but also to the person intended to be appointed in his place.

429. The Act makes no express provision for disqualification, for example, in the event of incapacity, a conviction for fraud, misconduct or bankruptcy. Nor does it provide for the situation which will arise if a duly appointed auditor becomes disqualified or wishes to resign during his period of office. We do not think the Act should attempt to prescribe the events (a conviction for fraud, bankruptcy, etc.) upon which a person should become disqualified. When the auditor is a member of a recognised professional body, this is a matter best left to the internal discipline of the body concerned: where his qualification depends upon an authorisation granted by the Board of Trade, it should be left to the Board to withdraw their authorisation. On the other hand, we think the Act should expressly provide that an auditor who ceases to be qualified or incurs positive disqualification should automatically relinquish his office.

430. It has been suggested that provisions should be enacted dealing expressly with the right of an auditor to resign, but there is some difference of opinion on where this right should be exercisable. It is contended on the one hand that he should be allowed to resign during his tenure of office only with the consent of the company in general meeting, on the other, that he should be expressly permitted to resign with the consent of the company's directors. We doubt if this is a suitable matter for detailed regulation by statute. We appreciate the force of the argument that an auditor's duty is to the members and we can see the danger of allowing his appointment to be terminated by arrangement with the directors in cases where the auditor wishes to resign because of disagreement with the directors. On the other hand, we think it would be unreasonable to insist that an auditor who is unable to continue in office, for example, because of failing health should not be able to resign without the consent of the company in general meeting. We think that the Act should expressly recognise his right to resign but that the question of whether an auditor has improperly resigned should be left to the recognised professional bodies as a matter of professional conduct.

#### *Powers*

431. It has been suggested that the auditors of a company should be empowered to require the auditors of the company's

subsidiaries to furnish them with such information and explanations in relation to the affairs of the subsidiaries as they think necessary. We recognise the force of the argument that auditors who are required to report on group accounts should be entitled to information and explanations about the affairs of the subsidiaries. We think, however, that it would be invidious to give the auditors of the holding company a statutory right to obtain information from the auditors of subsidiaries and, in any case, the logical conclusion of the argument in favour of giving such a power would appear to be that the same auditors should be required to audit and report on the accounts of a holding company and all its subsidiaries; we think such a provision would be impracticable and undesirable.

#### *Form of auditors' report*

432. The principal bodies representative of the accounting profession were unanimous in criticising the terms in which auditors are required by the Ninth Schedule to express their report on a company's accounts. In the

first place, they point out that the essential duty resting upon auditors is to report whether in their opinion the accounts present a true and fair view, but that the Ninth Schedule requires the auditors to state expressly their opinions on a number of other specific matters (for example, whether proper books of account have been kept by the company). It is suggested that these express statements are unnecessary and that it should be enough for auditors who are satisfied about these matters simply to state their opinion on whether the accounts present a true and fair view. If they are not satisfied about any of these specific matters their report should be qualified accordingly and if a qualification were necessary, it would be more obvious in a short report.

433. These bodies also criticised the formula prescribed for the auditors' report on the accounts of a company which has taken advantage of the exemptions at present conferred upon banking, discount and insurance companies and shipping companies. Such a report is required to state that the accounts present a true and fair view subject to the non-disclosure of matters which by virtue of Part III of the Eighth Schedule are not required to be disclosed. In fact, it is contended, accounts that do not disclose these matters may present a view that is neither true nor fair and it is wrong to require auditors to use words which could be misunderstood.

434. We agree with both these criticisms and at paragraphs 435 (h) and (i) below we recommend the substitution of a new form of auditors' report, which is largely based on the submission made to us on this subject by the Institute of Chartered Accountants in England and Wales. If our recommendations in Chapter X are accepted the accounts of insurance companies and shipping companies will in future be required to present a true and fair view, so that the number of companies to which the modified report will apply will be substantially reduced.

435. **We recommend that:**

(a) if our recommendations elsewhere about exempt private companies are accepted, the Board of Trade should be empowered to authorise any person, who can satisfy them that, at the time of the publication of this Report, he was mainly occupied

in private practice as an accountant and was employed as the auditor of an exempt private company, to be appointed auditor of a company, provided that none of its securities had been quoted or offered to the public and that it was not the subsidiary of a company whose shares had been so quoted or offered; the Board should have power to revoke such authorisation;

(b) subsection (1) of section 161 should be redrafted to avoid giving the impression that members of bodies of accountants established abroad are regarded as not professionally qualified;

(c) every company should be required to appoint or reappoint an auditor at each annual general meeting;

(d) the appointment of an English firm to be auditors of a company should be deemed to be the appointment of all the duly qualified individuals who are from time to time members of the firm during

the period of appointment, but the appointment should be deemed to lapse, creating a casual vacancy, in the circumstances described in paragraph 427 above and the members of the firm should be required to inform the company as soon as such circumstances have arisen; substantially similar provisions should apply in the case of Scottish firms;

(e) a copy of the resolution required by section 160 (2) to be sent to a retiring auditor should also be sent to any person proposed to be appointed in his place;

(f) an auditor who during his tenure or office ceases to be qualified or becomes positively disqualified should thereupon automatically relinquish his office;

(g) the Act should expressly declare that an auditor can resign during his period or office;

(h) the Ninth Schedule should be amended to require the auditors' report to state:

(i) whether in their opinion the balance sheet and profit and loss account of the company (or, where group accounts are submitted, the said accounts of the holding company and the group accounts) are properly drawn up in accordance with the provisions of the Act so as to give a true and fair view of the state or the company's affairs at the date of its balance sheet and of its profit or loss for its financial year ended on that date; or

(ii) (in the case of a company which has taken advantage of the exemptions conferred by Part III of the Eighth Schedule) whether in their opinion the balance sheet and profit and loss account (or those accounts and the group accounts as the case may be) are drawn up in accordance with the provisions of the Act;

(i) the auditors' report should be required to contain any qualification which they think necessary in relation to the matters now mentioned in paragraphs 1, 2 and 3 (1) of the Ninth Schedule.

## CHAPTER XII

### BUSINESS AND COMPANY NAMES

#### *Business names*

436. The Registration of Business Names Act of 1916 met a demand of many years standing for legislation requiring persons finding under names other than their own to disclose their true names. This demand was brought to a head by the first world war which provided popular support for legislation to prevent persons of enemy extraction from carrying on business under names concealing their identity or even suggesting British origin. Trades of this immediate purpose survive in section 14 of the Act, which requires the Registrar to refuse to register a name unjustifiably containing the word "British" or any other word suggesting British ownership or control. But the Act is not confined in its application to traders of any particular nationality and although immediately occasioned by the war of 1914-1918 cannot properly be regarded merely as a war-time measure which has somehow managed to escape repeal.

437. The Act, as mended, requires firms and persons, including companies as defined in the Companies Act, who trade under names other than their own, to register with the Registrar of Business Names and to file with him the business name under which they are trading, the general nature and place of the business, and their true names and private addresses. The Registrar may, under section 14 of the Act of 1916 as amended by section 116 of the Companies Act, 1947, refuse to register an undesirable business name, but makes only limited use of this power. Section 12 requires the Registrar to keep an index of all the firms and persons registered under the Act. The Board of Trade has informed us that in fact they keep an index of the business names which are registered. We do not think an index of the names of the proprietors of registered businesses would serve any useful purpose and we think the section should be amended to require the Registrar to keep an index of the business names which are registered.

438. Although there seems no doubt that the obligation to register is widely disregarded, the register contains some 800,000 business names, of which many have been disused for years without the requisite notice at discontinuance having been given to the Registrar. Despite its serious imperfections the register appears to be extensively used by the public. From a sample enquiry undertaken on our behalf it is estimated that about 70,000 enquiries a year are made, but that the Registrar is able to help in only about half the cases because of the incompleteness of the register. Most enquiries are made with a view to discovering the names and private addresses of the owners of businesses for the purposes of debt collection, of establishing credit status or of taking legal proceedings. The major criticisms which we have received are, first, about the incompleteness of the register

and, secondly, that the Registrar does not refuse registration on the ground of undesirability of a business name identical with or closely resembling another business name already on the register.

439. We have found it easier to see the deficiencies of the present system of registration of business names than to suggest a satisfactory remedy. We have considered in the first place whether the register serves a sufficiently important purpose to justify its continued existence. Trade Protection Societies and others have asserted that a central register of the names and private addresses of those trading under business names - even though it is only 50 per cent. Effective - is of considerable assistance in tracing the owners of abandoned businesses. The scale on which the register is consulted appears to confirm this view. Moreover, the Board of Trade have told us that control of the use of undesirable business names would be more difficult to enforce, and more inconvenient for traders, in the absence of registration, since the Board would only be in a position to act when the use of undesirable names had been brought to their attention. We have come, somewhat reluctantly, to the conclusion that the register should be maintained and we think that in future it should be kept in a form in which it can be made directly accessible to the public.

440. We have therefore considered various proposals which have been made to secure better compliance with the registration requirements. We think that failure to register is probably due for the most part to ignorance of the law on the part of many small traders, and perhaps also in some degree to the fact that (apart from compliance with the law) registration confers no advantage. We doubt whether any reasonable increase in the maximum penalty for default, which at £5 a day is already substantial for a small trader, would achieve a sensible improvement. It has been suggested that all traders who have registered should be given a number and required to exhibit the number at their place of business and on their business correspondence. Failure to exhibit the number by a business trading under a name obviously not that of the proprietor - e.g. "The Old Curiosity Shop" - would indicate default. The degree of regimentation involved in this proposal and any attempt to enforce it might however reasonably give rise to resentment. Moreover it would not serve its professed purpose in more than perhaps a relatively small proportion of

cases, since a person who traded under a surname other than his own without displaying a number would not thereby necessarily indicate that he was in default.

441. It has also been suggested that the Board of Trade should send enforcement officers round the country. But any large scale enforcement campaign would no doubt be expensive and we see no good reason for making enforcement a charge on the taxpayer. The best that we can suggest is that the fees charged to the public for use of the register should be substantially raised - witnesses have agreed that the present fees are low - and that a small annual registration fee should be imposed. The latter would encourage those who cease to use a business name to report the fact to the Registrar, as they are now required to do by the Act but generally fail to do, and failure to pay would indicate to the Registrar which names might no longer be in use. The additional income might

be used by the Board of Trade to give more publicity to the statutory requirements and possibly to employ some enforcement officers. The activities of the latter, even though relatively limited in their scope, would no doubt come to public notice in due course and lead generally to better compliance with the Act.

442. We have been informed by the Board of Trade that the provisions of section 428 of the Companies Act which empower the Court to make an order requiring a company or its officers to make good certain defaults under the Act have proved efficacious in cases where repeated prosecutions have not. We think a similar power, suitably adapted, would be useful in relation to defaults under the Registration of Business Names Act.

443. The second major criticism of the present arrangements is that the Registrar of Business Names does not regard as undesirable, within the meaning of the Registration of Business Names Act, a business name which is identical with or too like one already on the register; it has been suggested to us that in this respect, he should follow the example of the Registrar of Companies, who does consider a company name undesirable within the meaning of the Companies Act and refuses to register it, if it is identical with or too like that of a company already on the register of companies. The Board of Trade have explained the position and their difficulties to us as follows:

"The Registrar of Business Names on being charged in 1947 with the responsibility of preventing the registration of undesirable business names, found himself in charge of a register, built up over the previous thirty years, which has not indexed in a form adapted for checking against identity or similarity of names, since before 1947 he had had no responsibility of this kind. In any case even if the Register of Business Names had been kept in a manner which made inspection for similarity possible its contents were inadequate for the purpose; if a trader does business under his own name he need not register and it was notorious that a large number of names which should have been registered were, in fact, not registered. There seemed to be little utility therefore in checking against such a register.

. . . . .

Except as mentioned below, the Registrar, when he receives an application to register a business name does not search the index of business names the index of company names in order to ascertain whether there is already on the registers a business or company with an identical or similar name. He would however refuse an application to register a 'business name which was identical with or very similar to a trading name which was widely known and of which he was aware; but he would do this to protect the public, not to protect the owner of the name. When a company name is to be registered no search is made of the business names index. Only when a contract applies to register a business name does the Registrar search the index of company registrations in order to ascertain whether there is on the register a company with a name closely similar to the proposed business name. Such a search of the companies register is not made when the application comes from an individual or an unincorporated partnership."

We agree that since any number of Adam Smiths may trade under their own name there is little point in restricting the use of "Adam Smith" as a business name to one business. But in any event, we have been sufficiently impressed by the difficulties facing the Registrar of Companies-

with a register of some 400,000 companies - in preventing the use of too similar company names to be convinced that it would be impracticable to prevent similarities in the register of 800,000 business names, and still more impracticable in any combined register of over one million company and business names such as some witnesses have proposed. We therefore do not think that the Registrar of Business Names can reasonably be expected to do more than he does at present with regard to similar names.

444. It has been pointed out to us that owing to the definition of "firm" in section 22 of the Act, an unincorporated association of persons is registrable only if the members have entered into partnership with a view to "carrying on business for profit". There are, however, said to be a number of pseudo-professional and other associations, not ostensibly an organism with a view to carrying on business for profit, whose promoters and organisers may obtain the actual profits by way of remuneration. The Committee on Consumer Protection appointed by the President of the Board of Trade under the Chairmanship of Mr. J. T. Molony, Q.C. and several witnesses have suggested to us that some of these associations seriously mislead the public by adopting pretentious names, and that the Act should therefore be extended to enable the Board of Trade to control them. On the other hand, if every association, whether carrying on business for profit or not, were required to be registered under the Act and subject to Board of Trade control every tennis club would come within its scope. We suggest that this problem could be met by extending the Registration of Business Names Act so as to give the Board of Trade power to require an association, not carrying on business for profit, to stop using a name which in the opinion of the Board was undesirable. Such associations would, however, continue to be free from the requirement of registration under the Act.

445. Our attention has also been drawn to the fact that the Registration of Business Names Act applies only to persons and firms, trading under names other than their own, who have a place of business in the United Kingdom: an accommodation address is, for this purpose, not considered to be a place of business. We have considered whether the Act should be extended to cover itinerant traders with no established place of business but, in the absence of any substantial body of evidence that serious harm is caused by their omission from

the register and having regard to the, no doubt considerable, practical difficulties involved in enforcement of any such extension, we have come to the conclusion that the law should not be changed in this respect.

446. It has been suggested to us by the Board of Trade that it may be in the public interest for certain business descriptions to be controlled and that companies, firms and individual traders ought not to be free, without justification, to use such business descriptions as "bank", "bankers", "trust", "charity ", "corporation", "co-operative" or "building society ", since they are not permitted to use names which contain these words unless there is justification. The kind of abuse which it is sought to prevent is, for example, a company which has been refused the name "The A. Smith Bank Ltd.", but allowed to register as "A. Smith Ltd.", describing itself on its notepaper and outside its place of business as A. Smith Ltd. (Bankers). We agree that this practice is undesirable but we think that a general control

over the use of even a limited number of descriptions would be going too far: logically such a control would have to extend to the use of the description in any context such as in circulars or correspondence as well as in conjunction with the actual name. Moreover, such a control would have to extend to individuals doing business under their own name. We have not, therefore, made any recommendation about the use of business descriptions.

447. We make a number of relatively minor proposals about business names in paragraph 456 (g-j) below.

#### *Company names*

448. Section 17 of the Companies Act prohibits the registration of a company by a name which is, in the opinion of the Board of Trade, undesirable. The Board have explained the policy which they follow in deciding whether or not a company name is desirable thus:

"The main criterion of undesirability followed by the Board of Trade been the question of what is misleading, see example:

(a) falsely suggestive of Royal patronage or connexion with the Government or with local authority.

(b) falsely suggestive of official connexion with foreign Governments or statutory or government corporations or bodies incorporated by Royal Charter.

(c) pretentious or otherwise falsely indicative of the mixture of the company.

(d) calculated to lead to confusion by being identical with a registered trade mark which is not the property of the company.

(e) calculated to lead to confusion by resemblance to the name of an existing company. This last category subdivided into

(i) names which so resemble the name of an existing company that the public are likely to confuse the two; or

(ii) names which resemble the name of an existing company in such a way that the public are likely to assume that two independent companies are associated as holding company and subsidiary or otherwise.

The Board consider that the first primary function in the control of names is to prevent the public being deceived by names which are misleading either because of too great similarities or because they are too grandiose or for other reasons. In preventing too great similarity among names they are primarily protecting the public from being misled. Although by successfully doing this they will incidentally protect a company's vested interest in its own name they do not consider this to be the primary purpose of the legislation."

449. We have received little serious criticism of the general arrangements for preventing the use of undesirable company names which seem to have worked reasonably well in practice, though the Board of Trade have pointed out that with the ever growing number of company registrations it is becoming increasingly difficult to find new names which are not too like existing ones. We understand that the Registrar of Companies, although not statutorily required to do so, gives the grounds on which it has been decided by the Board of Trade that a particular name is undesirable. We think it

is important that he should continue to do this. We are satisfied that the present arrangements should, in the main, continue, but we deal in the paragraphs which follow with the more important proposals for improvement which have been made.

450. First, our attention has been drawn to legislation in some Commonwealth countries where the Registrar has power to reserve a name on application for a period of 30 or 60 days, and the applicant is required to publish the proposed company name in the press. This publicity gives interested persons wishing to do so an opportunity to raise objections in advance of registration. In this country, however, where applications for company names are running at a rate of some 250 a day, the introduction of a system of this sort would be of little practical use to existing companies unless they went to the expense of employing agents to maintain a constant search of the published lists on their behalf. In our view it is unnecessary to introduce such a system in this country. We do, however, agree that the Registrar should be given (and exercise on request) the power, which he does not possess at present, to reserve a name for, say, 30 days. At present, promoters must proceed with the preparation and submission of documents in uncertainty until the last moment whether the name which has been provisionally approved by the Registrar will be finally allowed, though it is right to add that in practice a provisional approval is relatively seldom reversed. There should be a fee of, say, five pounds for the reservation of a name. As well as helping to cover administrative costs we think this is necessary to discourage the reservation of an excessive number of names in connexion with the formation of one company or where there is no serious intention of forming a company at all.

451. Secondly, it has been pointed out to us that control over the use of undesirable company names has been evaded by incorporating abroad by an undesirable name and then establishing a place of business in Great Britain. We do not think it would be either practicable or desirable to institute any general control over the use in Great Britain of their own names by companies incorporated outside Great Britain and any attempt to do so might lead to the introduction of similar measures against British companies operating abroad. Moreover, section 411, which inter alia requires a company incorporated abroad to state the country of incorporation in business letters, etc., goes some way to deal with this problem, and we

think that this section, together with the remedy of a "passing off" action, provides adequate protection both to the public and to companies against the use of too similar names by overseas companies. However, we agree with the suggestion that control by the Board of Trade should, if possible, be extended to the names of companies incorporated abroad but having an established place of business in Great Britain, where such names would be refused on grounds other than similarity if incorporation were sought in this country.

452. Thirdly, the practice of the Registrar of Companies in dealing with resemblances between company names and trade marks has been criticised. Until about a year ago the Registrar required an applicant for a company name to give an assurance that the name he was requesting was neither identical with nor too closely resembled a registered trade mark in the

class of goods in which the company proposed to deal, It was the practice of the Registrar not to allow a company to be registered under a name identical with or resembling a registered trade mark unless he was given an undertaking that the company would not deal in goods for which the trade mark was registered or that the owner of the trade mark did not object. More recently, the Board have changed this practice on the ground that it put an impossible burden on the applicant, and the statement required by the Registrar, while still requiring an assurance that the proposed name is not identical with a trade mark, no longer contains any reference to resemblance.

453. We think the change was justified; the question whether a name too closely resembles a trade mark can be extremely difficult and we think it was unreasonable to impose on the applicant, an interested party, the responsibility for deciding it. A more valid criticism is that there is no crucial search of the register of trade marks for this purpose. We recognise, however, that it would add immensely to the burden already imposed on the Registrar and his staff and that it might also cause considerable delay in the registration of company names, if he were required to conduct the necessary search in the register of trade marks. So far as we are aware, cases in which the interests of an owner of a registered trade mark are prejudiced under the present system, are infrequent and, if our recommendation at paragraph 456 (n) below is accepted, the owner of a registered trade mark who thinks his interests have been jeopardised will at any time within six months of the registration of the company name in question be able to request the Board of Trade to direct the company to change that name on the ground that it too closely resembled his registered trade mark. We do not, therefore, recommend any change in the practice now followed by the Registrar.

#### *Change of company's name*

454. At any time up to six months from the date of incorporation of a company or of its registration by a new name, the Board may, under section 18 (2), direct a company to change its name if, through inadvertence or otherwise, a company has registered by a name which is, in the opinion of the Board of Trade, too like the name of an existing company;

but the Board have no power to direct a change of a name which in their opinion is undesirable on other grounds than similarity. Experience has shown that this power, which is very infrequently used, is necessary to rectify mistakes, and we agree that it should be extended to cover undesirability on any ground. We also think that the Board of Trade should be given power to direct a company to change its name at any time if the name has become misleading in such a manner as to be liable to cause harm to the public. We think that this power is necessary to prevent, for example, a company from continuing to use a name including the word "bank" if its activities no longer include banking business. We envisage that this power would be used by the Board of Trade very sparingly and there should be a right of appeal to the Court.

*Disclosure of names of company directors*

455. Section 201 requires the names of directors to be shown in all business letters and in trade circulars, trade catalogues and showcards if the

company's name appears in them and if they are issued or sent by the company to any person in any part of Her Majesty's dominions. There is an exemption for companies incorporated before 23rd November, 1916, and the Board has power to grant exemption where they consider that there are special circumstances which render it expedient to do so. We have considered whether this section serves a useful purpose: while it may be of some convenience to persons dealing with a company to see the names of its directors on the notepaper instead of going to the Companies Registration Office or to the company's own registered office to obtain this information, we agree that particularly in the case of larger companies, where changes in directors may be frequent, the requirement may be unduly onerous. This is borne out by the fact that, as we were told, new applications for exemption from the requirements of the section were granted at the rate of about 300 a year and applications for renewal at about 900 a year. We have received no evidence that this widespread exemption has caused any harm and we recommend that the section should be repealed. (In paragraph 456 (h) below we recommend that a modified form of the analogous requirements on individuals and firms, imposed by section 18 of the Registration of Business Names Act. should be retained.)

**456. We recommend that:**

**(a) section 12 of the Registration of Business Names Act should be amended to require the Board to keep an index of the business names on the register;**

**(b) the index of business names should be cleared as far as possible of "dead wood", and be arranged in a form in which it might be made directly accessible to the public;**

**(c) there should be a substantial increase in the fees charged to the public for use of the register of business names and a small annual registration fee should be imposed for registration;**

(d) the Board of Trade might give more publicity to the statutory requirements Imposed by the Registration of Business Names Act and employ some enforcement officers

(e) the Registration of Business Names Act should empower the Court to make n order requiring defaults under the Act to be made good (cf. Companies Act, section 428);

(f) the Board of Trade should have power to require an association, not "carrying on business for profit" within the meaning of the Registration of Business Names Act, to stop using a name which in the opinion of the Board is undesirable;

(g) section 2 of the Registration of Business Names Act should be amended so that it applies to the general agent of any firm, individual or corporation whose principal place of business ff situate outside the United Kingdom;

(h) section 18 of the Registration of Business Names Act should be amended to apply only to business letters and to require a proprietor trading under a business name to give his present name and any former name but not his nationality;

(i) the Registration of Business Names Act should apply to on bodies corporate incorporated in the United Kingdom (and not merely to companies at defined in the Companies Act) and to bodies corporate incorporated outside the United Kingdom having a place of business in the United Kingdom;

(j) companies should be required to disclose in their annual returns to the Registrar of Companies their registered business names, if any;

(k) the Registrar of Companies should be given power, which he should exercise on request, to reserve approved company names for a period of, say, 30 days; there should be a reservation fee of, say, £5;

(l) the Registrar of Companies should continue his present practice of giving the grounds on which the Board of Trade have decided that a proposed name is undesirable;

(m) the Board of Trade should be empowered to control the corporate names of companies, incorporated abroad and having an established plate of business in Great Britain which are, in their opinion, undesirable on grounds other than similarity;

(n) section 18 (2) should be amended to empower the Board of Trade to direct a company to change its name, within six months of registration, if the Board or Trade consider the name undesirable on any ground;

(o) the Board of Trade should be empowered to direct a company to change its name at any time if the name has become misleading in such a manner that it is likely to cause harm to the public. There should be a right of appeal to the Court;

(p) section 201 should be repealed.



## CHAPTER XIII

### COMPANY MANAGEMENT AND ADMINISTRATION

#### Meetings

##### *General meetings*

457. Section 131 requires every company to hold a general meeting as its annual general meeting once in every year and provides that the interval between such meetings shall not exceed fifteen months; we understand that in this context "year" means "calendar year". We think it important that general meetings should be held at regular and reasonably frequent intervals and we do not think that there should be any general relaxation of the rule laid down in section 131. It has been suggested that an exception might be made for a wholly owned subsidiary but, as we have stated earlier in our Report, we think that if a holding company decides to carry on any part of its undertaking through a wholly owned subsidiary it should accept the full consequences of its decision. Occasionally, however, it proves impossible for a company to comply with the requirements of section 131 and, as the section is now drafted, the company is automatically in default. For example, it might become clear that a company would not be able to hold a meeting within the statutory period because no quorum would be available. It seems to us to be wrong that a company should become guilty of even a technical offence where its failure to hold a general meeting is due to causes beyond its control. Further, we have recommended in Chapter X that the annual accounts should be required to be laid at the annual general meeting (although the Board of Trade should be empowered to relieve companies of this obligation when circumstances justify this). We think that wherever possible the accounts should be laid at the annual general meeting, and that where, for instance, it had become clear that the accounts 'would not be ready within the statutory period for holding the annual general meeting, but would be ready shortly afterwards, it might be desirable to postpone the annual general meeting for a short period. We therefore agree with the suggestion made by a number of witnesses that the Board of Trade should be empowered to

extend the period within which a company must hold its annual general meeting. The Board already have the power, under section 131 (2) to assist a company which is in default, but we think they should also be empowered to assist a company which is endeavouring to avoid being in default.

*Extraordinary general meetings - requisitions*

458. Section 132 requires the directors of a company to convene an extraordinary general meeting of the company on the requisition of a prescribed number of members. If the directors do not within twenty one days of the deposit of the requisition proceed to convene a meeting, a meeting may be convened by the requisitionists or a prescribed number of them. It has been suggested that the purpose of this provision may

be defeated if directors, while sending out the notices within twenty-one days, call the meeting for a date, say, six months ahead. We think the section should be amended to enable the requisitionists to exercise their power of convening a meeting if a meeting has not been convened by the directors for a date within, say, twenty-eight days of the notice convening the meeting.

### *Quorum at meetings*

459. Section 134 provides that, in so far as the articles of the company do not make any other provision in that behalf, the quorum shall be two members for a private company and three for any other company. If our recommendation at paragraph 31 (a) for reducing the statutory minimum number of members of all companies to two is accepted, the statutory quorum provided by section 134 should also be reduced to two in all cases.

### *Resolutions*

460. The Act requires some powers of a company to be exercised "by the company in general meeting" (e.g. alteration of share capital, section 61), some by special resolution (e.g. alteration of articles, section 10) and others by ordinary resolution (e.g. the removal of a director, section 184). We do not support the view that the Act should be amended to provide generally for voting on such resolutions by postal ballot. Where there is any possibility of there being a difference of opinion between members about such matters we think there should be a meeting at which it may be discussed. Where the members who are entitled to vote are unanimous, however, we see no need for a meeting. Section 143 (4) appears to recognise that a resolution agreed to by all the members may be equivalent to a special resolution although the definition of special resolution in section 141 seems to require it to be passed at a general meeting. We think that the position should be clarified and that there should be an express provision in the Act that a resolution in writing signed by or on behalf of all those who would have been entitled to vote upon it at a general meeting shall be equivalent to a special or ordinary resolution (as the case

may require) passed by the appropriate majority at a general meeting convened by the appropriate notice.

461. There is wide agreement that the Act should no longer provide for extraordinary resolutions and we think that a special resolution should be required in all those cases in which an extraordinary resolution is now required under the Act.

### *Proxies*

462. Members of companies which have no share capital do not enjoy the right of appointing a proxy conferred by section 136 of the Act. We see no justification for this, since it is only by appointing a proxy (and thereby empowering him to demand a poll) that a member of a company without a share capital can hope to exercise his voting power at a meeting which he is unable to attend in person. Our suggestion in the following paragraph that a proxy should be allowed to speak at a meeting of any company is an additional reason for making this change. We therefore

think that section 136 should apply to all companies, whether they have a share capital or not.

463. Under section 136 (1) a proxy is allowed to speak only at a meeting of a private company; in our view a proxy should be allowed to speak at a meeting of any company. Under section 136 (1) a member of a company other than a private company may appoint more than one proxy to attend on the same occasion; we apprehend that this was designed to cover the case where a nominee holds shares on behalf of two or more beneficial holders and thus to enable the latter to exercise their voting rights separately by means of separate proxies. It is true that a proxy need not cast all his votes the same way, but, in our view that a proxy should be allowed to speak at a meeting of any company is accepted, we think the right to appoint more than one proxy should apply to all companies in order that separate beneficial holdings may be adequately represented at meetings. On the other hand, we think that there should be some limit on the number of separate proxies which a member may appoint and we suggest a maximum of two; this, of course, would in no way restrict the right of a member, to appoint two or more proxies in the alternative. We also think where two proxies are appointed the proxy forms should be required to specify the number of votes each proxy is empowered to cast.

464. We have received suggestions that any proxy form circulated by the board should, in respect of resolutions on special business, give the member the opportunity to direct his proxy to vote in favour or against or to exercise his discretion separately with respect to each resolution. A similar proposal was considered by the Cohen Committee who rejected it on the grounds that "difficulties would arise where complicated matters come before meetings and it might be necessary for the chairman to adjourn meetings at which in the light of the discussions it was thought desirable to amend the resolutions." While appreciating the force of these objections we nevertheless take the view that, when a board of directors circulates proxy forms, they should use a form which permits members to exercise freedom of choice. As to the possibility of amendments and adjournments, under our proposal a member may give discretion to his proxy to vote for an amendment and, if members do not wish to give any discretion, we think that an adjournment to consider amendments may be the reasonable and proper course.

*Notices and circulars relating to meetings*

465. Under section 141 notice of a meeting called to consider a special resolution must specify the intention to propose it as a special resolution. Under section 207 (1) (a) every notice of a meeting summoned to consider a compromise or arrangement under section 206 must be accompanied by a statement explaining the effect of the compromise or arrangement and in particular stating any material interest of the directors of the company, whether as directors or as members or as creditors of the company or otherwise, and the effect thereon of the compromise or arrangement, in so far as it is different from the effect on the like interests of other persons. There are also provisions relating to the contracts of, and the documents to accompany, notices of resolutions of which special notice is required.

Otherwise, the contents of notices are regulated by the articles of the company and by the rules of equity and the common law. Article 50 of Table A. for example, requires a notice of a general meeting to specify the general nature of any special business to be transacted at the meeting, "special business" being defined in article 52 to cover everything except certain routine matters to be transacted at an annual general meeting. The general rule laid down by the Courts is that a notice must state with reasonable precision the nature of the business to be transacted; and it has been held, for example, that, where the effect of the resolution will be to enable some of the directors to obtain a benefit which but for that resolution they could not in consequence of their fiduciary position obtain or retain, the purpose for which the meeting is called will not be properly stated unless the intended benefit to the directors is disclosed. If notice of a resolution is inadequate or misleading, the resolution will be invalid. Where a formal notice is accompanied by a circular set out the case for or against a resolution any actual or implied misrepresentation in the circular would, if it were material, vitiate the notice.

466. It is argued that these rules do not in their present form give adequate protection to members and it has been suggested that there should be an express provision in the Act requiring a board of directors who issue circulars relating to meetings to give a full explanation of the matters to be considered. It has also been suggested that the liabilities of a member issuing such circulars in a private capacity should be defined by the Act on the lines of section 84 of the Larceny Act, 1861.

467. It appears to us that the language of section 207 (1) (a) to which reference is made above, is really little more than declaratory of the existing law as applied to the case with which the section deals. It is difficult to see how directors could consistently with their duty do less than explain the effect of the resolutions to be proposed, and disclose any material interests of their own, and the effect thereon of the resolutions so far as different from their effect on the like interests of others. It may no doubt be said that if this is already the law there is no need of any statutory provision about it. There is force in this argument. On the other hand, the fact that section 207 (1) (a) makes specific provision for a particular case coupled with the fact that there is no

general provision in the Act prescribing the duties of directors in relation to circulars dealing with matters to be discussed at meetings may mislead directors and other officers of a company into thinking that they need do no more than comply with the specific provisions of the Act. On the whole, therefore, we think the inclusion in the Act of a general provision declaratory of the existing law on this matter may serve as a reminder to directors and other officers of duties of which they may not be fully aware. The provision we have in mind would require directors who issue a notice or other circular relating to a meeting of a company or of any class of its shareholders, to state with reasonable precision the nature of the business to be transacted, giving such explanations and additional information as may be necessary, and in particular, where such information is material, disclosing any interests of the directors in the proposed transactions and the effect thereon of those transactions so far as it differs from their effect on the like interests of other members. As to the position of a member who issues circulars

in his private capacity we do not think that his present position is so strong that the directors or his fellow members need to be protected against him by special legislation.

468. We recommend that:

(a) the Board of Trade should be empowered to extend the period within which a company is required to hold its annual general meeting;

(b) section 132 (3) should be amended to provide that the requisitionists may convene a meeting if the directors do not convene the meeting required by the requisitionists for a date not later than, say, 28 days of the notice convening the meeting;

(c) section 134 (c) should be amended to fix a quorum of two members for all companies;

(d) there should be an express provision in the Act that a resolution in writing signed by all those who would have been entitled to vote upon it at a general meeting shall be equivalent to a special or ordinary resolution (as the case may require or as the resolution may state) passed by the appropriate majority at a general meeting convened by the appropriate notice;

(e) all reference to extraordinary resolutions should be omitted from the Act and special resolutions should be required in those cases where extraordinary resolutions are now required:

(f) members of companies which have no share capital should be given a statutory right to appoint proxies;

(g) a proxy for a member of any company should have a statutory right to speak and a member of any company should be entitled to appoint not more than two proxies to attend on the same occasion (not including alternates) provided that the member specifies the proportion of his holding that each proxy represents;

(h) proxy forms issued by a board of directors should be required to be so framed that the member may instruct his proxy to vote for or against (or to exercise his discretion in respect of) each resolution dealing with any special business to be transacted at the meeting which the proxy is to attend, "special business" being defined as in article 52 of the current Table A;

(i) a general provision should be added to the Act prescribing the duties of directors in respect of notices and other circulars relating to meetings on the lines proposed in paragraph 467 above.

#### Location of Statutory Books

469. Under section 110 the register of members must be kept either at the registered office of the company or the office at which it is made up; unless the register has at all material times been kept at the registered office, notice of the place at which it is kept and of any change in that place must be sent to the Registrar of Companies. Other statutory books and documents, such as minutes of general meetings, the register of directors and secretaries, the register of directors' share-holdings (subject to section 195 (7)), copies of instruments creating charges

registrable under section 95 and the company's own register of charges must all be kept at the company's registered office. We think that these documents should be subject to the more flexible provisions relating to the register of members.

470. We recommend that the provisions of the Act relating to the place at which the register of members is to be kept and

to the notice thereof to be given to the Registrar of Companies should be applied to the statutory books and documents mentioned in paragraph 469 above.

### **Share Transfer and Registration Procedure**

471. A Committee, representative of various City institutions and under the chairmanship of Lord Ritchie, issued a report in December, 1960, on the transfer of securities. We understand that proposals based on the recommendations of that Committee, which were directed to the simplification of the present system of transferring securities, have recently been submitted to the Government for consideration. We do not, therefore, propose to deal in our Report with the questions with which that Committee was concerned.

#### *Shams and stock*

472. Section 61 provides, inter alia, that fully paid up shares of a company may be converted into stock and section 62 requires such conversions (and other changes in share capital) to be notified to the Registrar of Companies. There were solid practical advantages in such conversions until the Companies Act, 1948, abolished, with some minor exceptions to which we refer below, the need to distinguish each share by its appropriate number. Nowadays the advantages of such a conversion, from the point of view either of the company or of its members, seem to be negligible and it has been submitted to us that the use of "stock" in this sense leads to unnecessary confusion. We agree that the existing distinction between "stock" and "shares" serves no useful purpose but we hesitate to recommend that all stock should be required to be re-designated as shares on share certificates and elsewhere because this would impose a considerable burden on many company registrars for no sufficient purpose. We think that the present references to "stock" should be eliminated from the Act, which should provide that the interests of the members of a company with a share capital should be deemed to be shares, whether the company describes them as shares, stocks or otherwise. There would then be no obligation imposed upon companies to re-designate as shares any stock in issue but we expect that, over a period and at their convenience, companies would do so. We have not considered in detail what transitional provisions might be involved in this change but

we recognise that provision would have to be made for determining the denomination of the shares which the holders of existing stock would thus be deemed to hold and for ensuring that their rights of voting and of transferring their interests were not prejudiced.

473. Section 74 provides that "if at any time all the issued shares in a company, or all the issued shares therein of a particular class, are fully paid and rank *pari passu* for all purposes, none of those shares need thereafter have a distinguishing number .... " Several witnesses have

drawn our attention to practical difficulties which arise under section 74 if new shares are issued which will not rank for the next dividend but otherwise will rank *pari passu* for all purposes with existing unnumbered shares. In these circumstances section 74 requires both the new and the existing shares to be numbered. This difficulty would be avoided if section 74 were amended so that, in the event of new shares being issued on terms which, while not making them uniform in all respects with existing shares at the time of issue, would make them become uniform in all respects within, say, one year of issue, neither the existing nor the new shares would be required to be numbered but the share certificates of the new shares would have to be appropriately worded or enfaced.

474. Our attention has been drawn to Clause 63 of the Australian draft Uniform Companies Bill which empowers the Court to make an order validating a creation or issue of shares which was invalid for any reason. The Court may make an order validating the issue or confirming the terms of issue, upon application by the company or by a holder or mortgagee of any such shares or by a creditor of the company, upon being satisfied that in all the circumstances it is just and equitable to do so. We think this would be a useful provision and recommend its inclusion in a new Companies Act.

#### *Delayed share transfers*

475. We have received criticism that the registration of a transfer of shares is at times deliberately delayed by the transferee (sometimes by arrangement with the transferor) in order to conceal from the directors the concentrated purchase of a company's shares, or by the direction of a company in order to prevent the transferee from exercising his voting rights at a company meeting. We hope that our proposals for the registration of share transactions by beneficial owners of 10 per cent. or more of the equity share capital, or any class thereof, of quoted companies, within 7 days of such transactions coming to their knowledge (see paragraph 147) will deal with complaints of the first sort.

476. We would deal with delay by the directors by amending section 78 and 80. Section 78 requires a company which refuses to register a transfer to send notice of the refusal to the transferee within two months after the transfer has been lodged. Section 80 requires the company to have ready for delivery a share certificate within two months of allotment of shares or receipt of a transfer unless the conditions of issue otherwise provide. We think that it would be reasonable to require a company in future to decide whether it refused to register a transfer, and to send notice of such refusal (to the transferor as well as to the transferee), within, say, five weeks of the lodging of transfer, and to have ready for delivery certificates giving effect to approved transfers (as distinct from certificates following an allotment) within the same period. There should be no proviso permitting an extension of this period by the conditions of issue or otherwise. We further suggest that the Act should provide, possibly by an appropriate extension of section 116, for an application by the transferee to the Court, on the showing of good cause, for an Order that the transfer should be registered forthwith. We have suggested

a maximum period of five weeks in sections 78 and 80 (except for issues of certificates following allotments) because we think that, in modern conditions and with modern office machinery, the transferee should not be expected to wait any longer. A period of five weeks would still allow transfers to be considered at board meetings held at monthly intervals. We believe that our recommendation in this respect complements those by Lord Ritchie's Committee which aim at simplifying and expediting transfer procedure.

### *The share register*

477. Section 110 requires a company to keep a register of members. In addition to particulars of existing members the register must include those of all past members and the date when they ceased to be members. We consider, in paragraph 481 below, the periods for which records of past members and also transfer deeds, paid dividend warrants and other documents should be retained.

478. It has been suggested that the Act should be amended, if necessary, to enable the register to be kept by the use of punched cards or other mechanical or electrical means. We would not agree to any change in the law which restricted the availability for inspection by the public of the information contained in the register. But, subject to this important proviso, we think that the law should not stand in the way of the introduction of labour saving methods of keeping records.

479. It has also been suggested that section 113 (2) should be amended to give a company more than ten days to provide copies of the register of members. We do not think that this period could properly be increased without a corresponding increase in the minimum notice required to be given of meetings of the company. Otherwise a member wishing to circularise other members to seek their support at a meeting would have insufficient time to do so. On balance we have come to the conclusion that the administrative difficulties, advanced as the reason for increasing the time for copying the register, are not so great as to outweigh the disadvantages for a company in the consequential extension of the minimum notice to be given of a meeting. We would therefore make no change.

480. We make further suggestions, of a relatively minor character, affecting the share register in paragraph 483 (g-i) below.

*Preservation of documents*

481. The evidence we have received indicates that the need to the documents and records relating to past transactions causes trouble, especially to large old companies. Entries in the share register relating to put members have to be preserved indefinitely, with the result that a large company whose shares are rapidly turned over accumulates a large and ever increasing stock of "closed accounts". We were informed that one company had accumulated 150,000 closed accounts during the forty years up to 1956. Furthermore, while the Act does not require the preservation of such documents as instruments of transfer, letters of allotment, allotment lists, paid dividend warrants and dividend lists, many companies think it necessary for their own protection to preserve these documents indefinitely. So far as documents relating to the payment of dividends

are concerned, we do not see the need for any special exemption from the law relating to the limitation of actions. As regards instruments like share transfers and signed letters of allotment, which affect the title to shares, the most we can suggest is a statutory provision to the effect that the accuracy of any entry in a share register should not be liable to be impugned on the strength of transactions alleged to have occurred over thirty years ago. If a shorter period were prescribed an exception would, in our view, be called for in cases where fraud was alleged and, if such an exception were made, companies might still think it necessary to preserve the original documents of title. After thirty years we think that any entry in the register could reasonably be held free from such challenge. Companies could then safely destroy the original documents of title and there would be negligible risk of prejudicing the victims of past frauds. If this proposal is accepted, section 110 could also be amended to permit entries relating to past members to be destroyed after thirty years.

#### *Liability of companies for certification of transfers*

482. The representation given by a company which certifies a transfer of shares or debentures is defined by section 79 of the Act; the certification is taken as a representation that there have been produced to the company such documents as on the face of them show a *prima facie* title to the shares or debentures; the section expressly provides that certification does not include a representation that the transferor has any title. This provision has been criticised on two grounds; in the first place, it is said that it should be extended to apply to certifications given by officials of stock exchanges. In the second place, it is suggested that the protection given to a person taking shares on the faith of a certification is less than it should be; where a share certificate containing inaccurate statements is produced to the transferee the company will be estopped from denying the truth of those statements; if the company certifies a transfer on production to it of an inaccurate share certificate, there is no estoppel. It is argued that a transferee who relies on a certificated transfer should be put in the same position as a transferee who relies on the actual share certificate. It is also said that subsection (3) of section 79 makes it too easy for a company to avoid responsibility for a certification since it requires the officer issuing the certificated instrument of transfer to have actual authority. If there is

any doubt about the construction to be placed on this provision we think it should be made clear that the company is bound by the act of an agent having apparent authority to act for the company. We think there is some force in the suggestion that a person taking shares on the strength of a transfer certificated on the faith of an inaccurate share certificate should be put in the same position as a person who actually has produced to him the inaccurate share certificate. We have, however, received no complaints that these apparent inconsistencies in the law have given rise to any practical difficulty and we have, therefore, refrained from making any recommendation.

**483. We recommend that:**

**(a) the new Act should provide that the interests of members of a company having a share capital should be deemed to be shares,**

whether the company describes them as shares, stock or otherwise there should be suitable transitional provisions to deal with the problems referred to in paragraph 472

(b) section 74 should be amended to provide that, where new shares are to be issued on terms which will make them become uniform in all respects with existing unnumbered shares within one year of their issue, neither the existing nor the new shares should be required to be numbered, but the share certificates of the new shares should be appropriately worded or en faced;

(c) the Court should be empowered to make an order validating the issue or confirming the terms of issue of shares invalidly created or issued, upon being satisfied that in all the circumstances it is just and equitable to do so. The company, a holder or mortgagee of any such shares, or a creditor of the company should be able to apply to the Court for such an order;

(d) a company should be required to decide whether to refuse to register a transfer and to send notice of such refusal (to transferor as well as transferee) within, say, five weeks after the transfer has been lodged, and to have ready for delivery certificates giving effect to approved transfers within the same period;

(e) the Act should provide for an application by the transferee to the Court, on the showing of good cause, for an Order that the transfer should be registered forthwith;

(f) the Act should permit, if it does not already do so, the register to be kept by the use of punched cards or by other mechanical or electrical means provided that this in no way restricts the availability, for public inspection in a legible form, of the information contained in the register;

(g) the Board of Trade should be empowered to fix maximum charges by statutory instrument, for copies of the register of members, or parts thereof;

(h) section 115 should be amended to make deer that a company may dose its register of members for the prescribed period of thirty days in respect of each class of shareholders without having to dose it in respect of all classes at the same time;

(i) the closing of the register should no longer be required to be advertised. Any person refused access to the register should be entitled to require a certificate born the company's secretary stating the period for which the register is closed by resolution of the board of directors pursuant to the provisions of the Act;

(j) It should be provided that the accuracy or any entry in a share register may not be challenged on the strength of transactions alleged to have occurred more than thirty years before the challenge;

(k) section 79 (3) (certification of transfers by officers of the company) should be amended to provide, if it does not already do so, that the company is hound by the act of an agent having apparent authority to act for the company.

## Returns to the Registrar of Companies

484. We have received a number of suggestions for amending the provisions of the Act relating to returns. These suggestions relate to the information required to be given and to the form in, and the time within, which it is required to be given. Many of them raise questions of drafting or of mechanical detail upon which we do not feel called to comment and we have passed these over to the Board of Trade. We discuss below only those suggestions which seem to us to raise questions of general interest.

### *Annual return - list of members*

485. Paragraph 5 of Part I of the Sixth Schedule requires the annual return to include a list of the names and addresses of members on the fourteenth day after the annual general meeting and of persons who have ceased to be members during the period to which the return relates, the number of shares held by each member and particulars of transfers effected during that period by both present and past members. It has been represented to us that this imposes a heavy burden on large companies and various suggestions have been made for reducing it. The Act already provides some relief, since under proviso (c) to section 124 (1) a company need not send in a full list of members more than once in three years; details of changes in membership and of share transfers, however, have to be included in each annual return. We cannot recommend any radical changes in these provisions: in our view, membership of a company is a matter of legitimate interest to the public and we agree with the Cohen Committee that it is important that they should have access to a record of such membership without having to go to the registered office of the company. We think, however, that it is unnecessary for the annual return to include the information now required about share transfers (see columns 4, 5 and 6 of the Table in paragraph 5 of Part II of the Sixth Schedule) and we think this should no longer be required. The requirement that the list of members should give the membership on the fourteenth day after the annual general meeting seems to us to be unduly rigid. If companies were given more latitude in this respect, we believe that they might be able to combine the labour of preparing a list of members for inclusion in the annual return with that of preparing dividend lists. We therefore suggest that the

list of members should be required to state the position on any day within two months before the last day prescribed in section 126 for the delivery of the annual return to the Registrar of Companies. Given the relaxations we have suggested above, we would withdraw the concession under proviso (c) to section 124 (1) and require a complete list of members to be submitted every year (together with a list of those who have ceased. within the 12 months to the date of the return, to hold shares in respect of which any amount remains unpaid). We think that, even for large companies, this simpler return will be no greater burden than the record of changes required under proviso (c) and it will facilitate searches by the public who may at present have to collate two or three separate documents to ascertain the membership at the date of the latest return.

#### *Annual return - charges*

486. By virtue of paragraph 4 of Part I of the Sixth Schedule and of section 125 (2) the annual rest of a company registered in Scotland

must include statements in respect of all mortgages and charges which would be required to be registered if the company had been registered in England. These provisions seem to us anomalous, particularly since the passing of the Companies (Floating Charges) (Scotland) Act, 1961, and we think the provisions mentioned above should be amended so that the annual returns of Scottish companies are required to include statements in respect of charges required to be registered by them.

#### *Particulars of directors*

487. It has been pointed out to us that, if a person who is a director of a number of companies retires from the board of one of them or joins the board of another, a return to that effect must under section 200 (4) be sent to the Registrar of Companies not only by the company from whose board he retires (or which he joins) but also by the other companies of which he is a director. This seems to us to involve a waste of time and labour and we think that section 200 (4) should require the return to the Registrar of Companies to be made only by the company of which the person in question becomes or ceases to be a director. The director should, however, be required, as we have recommended in paragraph 97 to inform all his companies of the change so that they can take account of it in their registers of directors and in their next annual returns to be submitted to the Registrar of Companies.

488. Our attention has been drawn to cases where the directors and secretary of a company resign simultaneously, leaving no officers to ensure that the company discharges its duty of notifying the Registrar of Companies of the resignations. We suggest that the resignation of a director or secretary should not relieve him of his duties as an officer of the company unless the director or secretary, having notified the company, had reasonable ground to believe that the company would notify the resignation to the Registrar of Companies.

#### *Return of allotments - section 52*

489. Under section 52 a limited company is required to make a return to the Registrar of Companies of the allotment of any of its shares within one month of the allotment. This return must give Inter alia the name, address and "description" of each allottee. We do not think that the description of the allottee is of any real value today and we think it should no longer be required.

490. We think that where a company's shares are allotted in the first instance to its members or any class of its members by way of a capitalisation issue or provisionally allotted on a rights issue (notwithstanding that in either of such cases there may be a right of renunciation) there is no need for the return of allotments to include the names of the allottees.

491. When shares are allotted as fully paid up otherwise than in cash, the return of allotments required by section 52 must be accompanied by the relevant contract or contracts or, if any such contract is not reduced to writing, by the prescribed particulars thereof. We agree with the suggestion that when such an allotment is made in pursuance of a scheme of arrangement taking effect under section 206 the delivery of an office

copy, duly stamped, of the order of the Court sanctioning the scheme should be a sufficient compliance with this requirement. We also agree that when shares are issued as fully paid on a capitalisation issue the preparation and lodging of a contract fulfils no useful purpose and we think it should be sufficient to require the company to deliver for registration a copy of the resolution whereby the shares were authorised to be issued credited as fully paid up.

### **Filing of additional information**

492. While most of the suggestions we have received are for the simplification of returns and the elimination of information thought to be unnecessary, we have received a few suggestions that some matters not now required to be notified to the Registrar of Companies should be required to be notified to him. We agree with some of these suggestions and have recommended accordingly in paragraph 495 (h) and (i) below.

### *Form of documents delivered to the Registrar of Companies*

493. The form in which documents must be delivered to the Registrar Companies varies; thus copies of resolutions increasing the nominal capital must be printed in all cases, copies of special and extraordinary resolutions must be printed unless they are resolutions of an exempt private company, annual returns may be completed in manuscript. For these separate and inconsistent rules we suggest there should be substituted one uniform rule requiring all documents delivered to the Registrar of Companies for registration to be legible and durable but not necessarily printed.

### *Functions of the Registrar*

494. The Act does not expressly confer upon the Registrar of Companies any discretion to accept or reject documents which are delivered to him for registration. The Registrar, however,

takes the view that he is not required to accept without question each and every document purporting to be delivered to him in pursuance of the Act without regard to its legality or effectiveness, or the authority of the person by whom it is delivered. We agree with this view; it would be absurd if the Act had the effect of requiring the Registrar to register the memorandum and articles of a company manifestly formed for an illegal purpose or to register a special resolution delivered in circumstances plainly indicating that it had never been properly passed. In Chapter VII above we have recommended that the Registrar should be empowered, subject to appeal to the Court, to refuse to accept for registration prospectuses relating to unquoted securities and circulars containing take-over offers, if they fail to set out the information required by statute or if they do so in a manner likely to create a false impression. In addition to these specific powers we think that the Act should expressly recognise the limited discretion which, in our view, is already by implication vested in the Registrar. He should be expressly empowered to reject any document which is manifestly ineffective because it purports to give effect to, or to record, an unlawful transaction or is not properly authenticated or does not comply with the requirements of the Act. He should not, however, be responsible for verifying the truth of any statements made in documents

delivered to him for registration, but cases inevitably arise in which the validity of, for example, a special resolution will depend upon facts which are disputed. In such cases the Registrar should have discretion to accept or reject the resolution and, subject to an appeal to the Court, for which express provision should be made, his decision on the disputed facts should be final.

495. We recommend that:

(a) annual returns should no longer be required to include the information relating to transfers of shares indicated in columns 4, 5 and 6 of paragraph 5 of Part II of the Sixth Schedule; the list of members should give the position on any day within two months before the last day for rendering the annual return and. proviso (c) to section 124 (1) should be repealed;

(b) the special references to Scottish companies in paragraph 4 of Part I of the Sixth Schedule and section 125 (2) should be omitted;

(c) the obligation imposed by section 200 (4) to send to the Registrar of Companies a return of any change in the directors of a company or in any of the particulars contained in the register of directors should be imposed solely on the company of which the person in question becomes or ceases to be a director; the director should, however, be required to inform all companies of which he is a director of the change so that the registers of directors of those companies may be amended accordingly;

(d) the resignation of a director or secretary should not relieve him of his duties as an officer of the company unless the director or secretary, having notified the company, had reasonable ground to believe that the company would notify the resignation to the Registrar of Companies;

(e) a return of allotments should no longer be required to state the description of the allottees;

(f) returns or allotments in connexion with capitalization or "rights" issues to members of any class or members should no longer be required to include the names of the allottees;

(g) where shares are allotted credited as fully or partly paid up otherwise than in cash in pursuance of a scheme of arrangement under section 206, the delivery to the Registrar of Companies of an office copy of the order of the Court sanctioning the scheme should, if it is duly stamped, be treated as a sufficient compliance with the requirements of section 52 (1) (A); in the case of capitalization issues it should be sufficient for the company to deliver for registration a copy of the resolution by which the shares were authorised to be issued credited as fully paid up;

(h) companies should be required to file with the Registrar of Companies:

(i) a copy of any document or resolution attaching rights to shares, not otherwise required to be filed;

(ii) a return in respect of the classification of any unclassified shares and in respect of the conversion of shares of one class into shares of another;

(iii) say ordinary resolution imposing a limit on the borrowing powers of the company's directors;

(i) where the directors' recommendation for the payment of a dividend is rejected or varied by the company in general meeting, a statement of the meeting's decision should be made in the relevant annual return;

(j) all documents delivered to the Registrar of Companies for registration should be required to be durable and legible but not necessarily printed;

(k) the Registrar of Companies should be expressly empowered to refuse to accept any document delivered to him for registration if it appears to him to be manifestly unlawful or ineffective: there should be a right of appeal to the Court against the Registrar's decision but subject to such appeal his decision should be final.

## CHAPTER XIV

### WINDING UP

496. The winding up of companies is regulated by Part V of the companies Act and by the Companies (Winding Up) Rules, 1949 made under powers conferred by that Act, and by the corresponding provisions in Scotland. The procedure for winding up is regulated in considerable detail and we have received numerous proposals for improving it. Many of these proposals, though concerned with procedural points of practical importance, do not, in our opinion, raise matters of principle which require discussion in our Report. Others are concerned with questions affecting insolvency generally and not simply insolvency of companies. We have passed such proposals to the Board of Trade for their consideration when a new Act and new Winding Up Rules come to be drafted, and we have confined our recommendations in the paragraphs which follow to matters which, we consider, raise points of general principle relating to companies.

#### *Directors of insolvent companies*

497. There is widespread criticism that the Companies Act as a whole does not at present deal adequately with the situation arising from fraud and incompetence on the part of directors - particularly directors of insolvent companies - and the relevant sections of the Act are considered below.

498. Section 187 of the Companies Act provides that an undischarged bankrupt shall not act as a director of, or directly or indirectly take part in the management of, a company without leave of the Court by which he was adjudged bankrupt. Section 188 provides that persons guilty of offence, in connexion with the promotion, formation or management of a company or of fraud or breach of duty in relation to a company may, by order of the Court, be prohibited for a period not exceeding five years from being a director of, or directly or indirectly concerned in the management of, a company. We have already recommended in paragraph 85 (b) that section 188

should be extended to cover persons convicted of any offence involving fraud or dishonesty (whether in connexion with a company or not, persons who have been persistently in default in complying with the provisions of the Companies Act and persons who have been shown to have acted recklessly or incompetently in relation to the affairs of any company of which they are, or have been directors. Section 268 empowers the Court, at any time after the appointment of a provisional liquidator or the making of a winding up order, to summon for examination any officer of the company known or suspected to have in his possession any property of the company or supposed to be indebted to the company. Section 270 provides that where the Official Receiver was reported that in his opinion a fraud has been committed by the promoter or any officer of a company being wound up by the Court in England, the Court may order him to be publicly examined. (Under section 269 in a winding-up

by the Court of a company registered in Scotland the Con has power to require the attendance of any officer of the company at any meeting of creditors or of contributories or of a committee of inspection for the purpose of giving information as to the trade, dealings, affairs or property of the company,) Section 332 provides that, if in a winding up it appears that any persons were knowingly parties to the carrying on of the business of a company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may declare such persons to be personally liable without limitation of liability for all or any of the debts or other liabilities of the company. The section also provides a criminal penalty for such conduct. Section 333 provides that if, in the course of winding up, it appears that any promoter, director, liquidator or officer of the company has misapplied or retained any money or property of the company or has been guilty of any misfeasance or breach of trust in relation to the company the Court can compel him to restore the property or to contribute such sum to the assets of the company as the Court thinks just.

499. If our recommended extension of section 188 is adopted a major point of criticism in this field will be met. But it is further suggested that the Act does not at present provide a sufficient deterrent to dissuade directors from continuing the business of a company which they know to be hopelessly insolvent; and that its efficacy in this respect would be greatly increased if the power of the Court to order public examination of directors of insolvent companies under section 270 were extended. Next, it has been pointed out that while section 332 provides criminal penalties for fraudulent trading if the facts are discovered in the course of a winding up, the section does not extend to fraudulent trading discovered in other circumstances, for example, as the result of an inspection by an inspector appointed by the Board of Trade. Our attention has also been drawn to the fact that section 333 does not provide a summary procedure to deal with actionable negligence by directors.

500. We think there is force in these criticisms and we make recommendations in paragraph 503 (a-d) below which are designed to meet them, We would, however, stress that the provision of additional powers will of itself achieve nothing. These powers will only serve a useful purpose if the Board of

Trade in particular are prepared to invoke them by applying in proper cases for Court action against fraudulent, reckless and incompetent company directors.

### *Receivers and managers*

501. Section 367 provides that an undischarged bankrupt may not act as receiver or manager, but exceptions are made where the appointment and bankruptcy were both before the commencement of the 1948 Act, and for appointments made by order of the Court, Rule 168 of the Companies (Winding Up) Rules, 1949 provides that a liquidator against whom a Receiving Order in Bankruptcy is made shall thereby vacate his office. It has been suggested, and we agree, that section 367 should disqualify undischarged bankrupts, without exception, from acting as receivers, managers or liquidators. We also agree that section 188 (power to restrain fraudulent persons from managing companies), amended in accordance

with our other recommendations, should be extended so that the Court might disqualify persons from acting as receivers, managers or liquidators for the same reasons and in the same manner as it may disqualify persons from acting as company directors.

### *Miscellaneous*

502. A number of miscellaneous points relating to winding up which have been brought to our notice and which we consider require attention are dealt with in our recommendations in paragraph 503 (g) to (v) below. Recommendation (g), relating to the position of a trustee in bankruptcy in winding up proceedings, goes beyond the recommendations on this point by the Blagden Committee on Bankruptcy Law and Deeds of Arrangement Law Amendment (see paragraphs 228 and 229 of their Report). Our recommendation, if adopted, would give a trustee in bankruptcy the same rights as the bankrupt contributory, and we do not, therefore, think that the position of other contributories would be unfairly prejudiced.

### 503. We recommend that:

(a) section 270 should be extended to empower the Court in England to order the public examination of all or any of the directors or other officers of an insolvent company where there is some *prima facie* case of culpability, or of such Impropropriety, recklessness or incompetence as might lead to disqualification of the person or persons concerned under section 188 (as we propose it should be amended);

(b) section 332 (1) should be extended to make directors and others, who have carried on the business of the company in a reckless manner, personally responsible without limitation of liability, for all or any of the debts or other liabilities of the company, if the Court so declares on the application of the Official Receiver or the liquidator or any creditor or contributory of the company. The criminal penalty provided in section 332 (3) should not, however, extend to reckless trading;

(c) it should be made clear that section 332 (3) provides a penalty for fraudulent trading where the facts are discovered in other circumstances than in the course of winding up;

(d) section 333 (1) should be amended by substituting for "breach of trust in relation to the company" a reference to any breach of duty in relation to the company which would involve civil liability at the suit of the company. The effect of this change would be to bring actionable negligence of directors and others within the scope of the section. Section 333 (1) should also be amended to bring a receiver of any property of the company within its scope;

(e) section 367 should be amended to disqualify, without exception, undischarged bankrupts from acting as receivers or managers, and a similar disqualification should extend to acting as liquidator of a company;

(f) section 188 (amended in accordance with our other recommendations) should be extended to empower the Court to disqualify persons from acting as receivers, managers or liquidators for the same reasons and in the same manner as it may disqualify persons from acting as company directors;

(g) section 224 should be amended expressly to empower the trustee in bankruptcy or personal representative of a contributory to petition the Court for winding up;

(h) a contributory's petition for winding up should not fail merely because if an order were made there would be no assets available for the contributories;

(i) the Court should be completely free in the exercise of its discretion to wind up a company on the ground that it would be just and equitable to do so. Section 225 (2) should accordingly be amended to remove the existing limitations on the Court's power to exercise its discretion in this respect;

(j) when a petition is made for winding up otherwise than on the ground of insolvency, the form prescribed for the advertisement of such a petition should make it clear that insolvency is not alleged against the company;

(k) section 227 should be amended to empower the Court, between the date of the winding up petition and the date of the winding up order if any, to validate on such terms as it may think fit a disposition of the property of the company. The section should also make clear that, during the same period, the Court is similarly empowered to sanction the carrying on of the business of the company and acts incidental thereto, such as the drawing of cheques on its bank account;

(l) the Court should be empowered, on the application of the liquidator or any creditor, to direct that the winding up of a company, which had been ordered to be wound up by the Court, should thenceforth be conducted as if it were a creditors'

voluntary winding up. In exercising this power the Court should have regard to the wishes of the creditors and contributories of the company;

(m) in a voluntary winding up the liquidator's accounts should be required to be audited unless the committee of inspection or the members by ordinary resolution (as the case may require) otherwise determine. The proviso would enable those concerned to dispense with an audit if lack of company funds made this appear to them to be desirable;

(n) while continuing to require a declaration of solvency to be made before (but not more than five weeks before) the passing of a winding up resolution, section 283 (2) (a) should be amended so that the delivery of any such declaration to the Registrar of Companies should be required to be made not later than the delivery of the corresponding winding up resolution;

(o) in a members' voluntary winding up the liquidator should be removable by a special resolution (at a meeting convened by

any contributory), provided that notice of such resolution is sent to the creditors and the liquidator, and that any creditor or contributory may apply to the Court to stop his removal;

(p) section 287 (3) should be amended by deleting the condition that only members "who did not vote in favour of the special resolution" may express dissent;

(q) creditors at a meeting called under section 288 should be empowered to substitute, if they so wish, another liquidator (and fix his remuneration) with or without a committee of inspection. (The liquidation would from the date of the meeting be a creditors' voluntary liquidation);

(r) in order to speed the appointment of a liquidator In case of emergency, the directors should have power to deliver to the Registrar of Companies a declaration that the company cannot by reason of its liabilities continue its business and that meetings of the company and of its creditors will be summoned for a date not more than twenty-eight days after the date of the declaration. After delivering such a declaration the directors should be required to appoint forthwith a provisional liquidator to remain in office for twenty-eight days or such extended period as the Board or Trade may allow, or until the earlier appointment of a liquidator. The declaration and notice of the appointment of the provisional liquidator should be required to be advertised, and each notice to be delivered to the Registrar for registration. The date of the delivery of the declaration should be treated as the commencement of the winding up. The provisional liquidator should be protected by statute in relation to all acts properly done by him and should be entitled, out of the company's funds, to adequate remuneration and to reimbursement of all expenses properly incurred;

(s) if the proposals outlined in (r) above are adopted, provision for voluntary winding up by extraordinary resolution (as opposed to special resolution) will, in our view, no longer be necessary as the power of providing immediate interim protection by Eke appointment of the provisional liquidator will more than offset any disadvantage there might

otherwise be in the additional week's notice required for a special resolution. Accordingly no exception need be provided to our general recommendation, made elsewhere in this Report, that extraordinary resolutions should be abolished. However section 133 (3) which, *inter alia*, permits a meeting to consider a special resolution to be called by shorter notice than twenty-one days should be amended to preclude, In any circumstances other than a members' voluntary winding up, the calling of a meeting to consider a special resolution pursuant to section 278 (1) (b) by notice of less than seven days;

(t) a simple and inexpensive means of formally dissolving companies wound up by order of the Court - on the lines of sections 290 (dissolution of companies after members' voluntary winding up) and 300 (dissolution of company after creditors' voluntary winding up) - should be provided in addition to section 274, which, since it

involves the expense of an application by the liquidator to the Court, is rarely if ever used;

(u) section 352, which empowers the Court to declare the dissolution of a company void at any time within two years of the date of the dissolution, should apply only to companies dissolved regularly and formally in accordance with the provisions of sections 274, 290 and 300 and, if our recommendation at (t) above is accepted, the proposed new provisions for the dissolution of companies wound up by order of the Court. Companies struck off the register, pursuant to section 353, should not be within the scope of section 352 and should be capable of resuscitation within twenty years of striking off, as is now provided by section 353 (6);

(v) the provisions in the Companies Act for winding up subject to supervision of the Court (see particularly sections 311 to 315) serve no useful purpose and should be repealed.

## CHAPTER XV

### ENFORCEMENT OF THE LAW AND OTHER MATTERS

#### Problems of Administration and Enforcement of the Law

504. The value to the public of the Acts whose operation we have been asked to consider depends upon the extent to which they are effectively enforced. There is a strong feeling that the duty to register imposed by the Registration of Business Names Act is not adequately enforced and that the register of business names is by no means as useful as it should and could be; in that part of our Report dealing with Business and Company Names we have made such recommendations as we think practicable for securing better compliance with the registration requirements of that Act. We have also drawn attention to certain difficulties in the administration of the Prevention of Fraud (Investments) Act, but we have received little or no evidence that it is not effectively enforced. We confine ourselves in the paragraphs which follow to discussing the problems of enforcing the performance of the positive duties imposed upon companies and their officers by the Companies Act.

505. The Board of Trade, who are the Department charged with the enforcement of these duties, inform us that, except where fraud or misfeasance is in question and damage has been caused, they do not ordinarily proceed to prosecution unless requests to the company to comply with the Act have been made and failed. In view of the nature of many of the offences involved and the number and variety of companies concerned, we think the Board's policy is right.

506. Prosecution or the threat of prosecution, however, is not the only method of enforcement available under the Act. Thus, certain duties imposed upon a company may be enforced by an order of the Court under section 428; a company which allows the number of its members to fall below the statutory minimum or makes default in other specified respects is liable to be wound up by the Court under section 222; persistent and

prolonged default in rendering returns may result in its being struck off the register and dissolved under section 353. We think that in many cases the sanctions provided by these sections are more effective than prosecution and we think that they might be made available in a wider variety of cases.

507. We have been informed by the Board of Trade that their recent experience of the method of direct enforcement provided by section 428 indicates that an order of the High Court, backed by the sanction of committal for contempt of court, has proved effective where a long series of warnings and even prosecutions has not. We think this is a valuable section; its usefulness is somewhat limited, however, by the fact that it relates only to defaults by the company and only to defaults in complying

with those provisions of the Act which require it to furnish information to the Registrar. Thus, it would not apply to a failure by directors to lay accounts before a company in general meeting, nor to the failure of a company to hold an annual general meeting within the prescribed time. We think the section should be extended to cover both default by officers and defaults by a company in complying with any of its statutory duties. We have already recommended that a similar provision, suitably adapted, should be added to the Registration of Business Names Act.

508. Cases may arise where a company persistently fails to comply with the duties imposed upon it by the Act, but neither a prosecution nor an application for an order under section 428 is an adequate or appropriate remedy. We have indicated elsewhere that we attach particular importance to a company's having at least two directors: the threat of prosecution may induce a company to make up the number of its directors to the statutory minimum but where a company is left without directors or secretary neither prosecution nor an order under section 428 would be effective. We have already indicated that the imposition of an annual registration fee should do something to reduce the number of irresponsible registrations and to reduce the number of companies already on the register. We think the Court should be given the power on the application of the Registrar to order a company to be wound up if it is persistently in default in complying with the duties imposed on it by the Act; in particular, this general power should be exercisable if after the lapse of a prescribed period it had no secretary and less than two directors or had failed to pay the annual registration fee which we have recommended elsewhere. The power should also be available to enforce the underlying principle of the Act, that a company may be formed only for a lawful purpose. If it were brought to the attention of the Registrar of Companies that registration was being sought in order that the company to be registered should carry out an unlawful purpose (including a purpose lawful in itself but one which could not lawfully be carried out by a registered company) the Registrar would be entitled, and, indeed, bound, to refuse registration. We think there should be power for the Court to order the winding up of a company if it can be shown that it is being carried on for an unlawful purpose in the wider sense used above.

509. Winding up by the Court, however is a relatively elaborate and, therefore, expensive process which is not always justified. Cases have been drawn to our attention where the provisions of section 353 (which provides for striking off by the Registrar) were not applicable but where the existence of the company should be terminated though its assets did not justify the expense of a winding up; in one case the company had no assets and its managing director was in receipt of National Assistance. In such cases we think the Registrar should be empowered to apply to the Court for an order that the company should be struck off the register and dissolved without winding up. We hope that these powers would be used only in exceptional cases, since, in general, we do not think a company should be dissolved except upon completion of a regular process of winding up.

510. Section 438 makes it an offence for any person wilfully to make a statement false in any material particular, knowing it to be false, in

any document "required by or for the purposes of any of the provisions of this Act specified in the Fifteenth Schedule hereto." We cannot see why the offence should be limited to documents etc. required by or for the purposes of the provisions specified in the Fifteenth Schedule and we think that it should extend to documents required for any of the purposes of the Act.

511. We recommend that:

(a) section 428 should be extended to cover defaults by officers of the company and to cover defaults either by the company or by its officers in complying with any of their statutory duties;

(b) the Court should be empowered on the application of the Registrar of Companies to order a company which is in persistent breach of its statutory duties to be wound up; and in particular this general power should be exercisable if, after the lapse of a prescribed period, the company has failed to appoint a secretary or the statutory minimum of directors or has failed to pay the annual registration fee which we have recommended elsewhere;

(c) the Court should be empowered on the application of the Registrar of Companies to order a company to be wound up if it is satisfied that the company is being carried on for an unlawful purpose (including a purpose lawful in itself but one which cannot lawfully be carried out by a registered company);

(d) the Court should be empowered on the application of the Registrar of Companies to order a company to be struck off the register and dissolved without winding up, if in the circumstances, winding up would not be appropriate;

(e) the reference in section 438 to the Fifteenth Schedule should be repealed.

## **Foreign Companies and Other Matters**

### *Foreign companies*

512. The provisions of Part X of the Act apply to companies incorporated outside Great Britain. Sections 406-416 apply to such companies if they establish a place of business in Great Britain, when they are described as "oversea companies". Sections 417-423 apply to the issue in Great Britain of prospectuses and offers for sale relating to shares or debentures of companies incorporated outside Great Britain and apply whether the companies concerned have established a place of business in Great Britain or not.

513. Oversea companies must furnish the Registrar of Companies with copies of their constitutions, particulars of their directors and secretary and the name and address of at least one person resident in Great Britain authorised to accept on behalf of the company service of process and

notices; they must take steps to bring to the attention of persons with whom they may deal the name of the country in which they are incorporated and, if they are incorporated with limited liability the fact that they are so incorporated. They are also required to furnish accounts to the Registrar of Companies once in every calendar year. Certain charges created by these companies are registrable under Part III of the Act and in the chapter dealing with Loan Capital we have recommended that the category of registrable charges created by them should be extended. The Act does not impose any restriction on a company incorporated outside Great Britain which wishes to do business in Great Britain.

514. We think the general scheme of the Act is right and have received no fundamental criticism of its practical operation. In the chapter dealing with Business and Company Names we have recommended (a) that the Registration of Business Names Act should apply to foreign corporations having a place of business in the United Kingdom; (b) that the Board of Trade should be empowered to control the use by an overseas company of a name which is undesirable for any reason other than similarity to the name of a company already registered here. Our attention has also been drawn to some differences in the treatment of overseas and British companies which are said to be anomalous and suggestions have been made for making enforcement more effective and for facilitating the service of process on overseas companies. We think there are some minor anomalies in the treatment of the two classes of company but, as these do not raise any question of principle, we have thought it sufficient to refer them to the Board of Trade for their consideration.

515. An overseas company which fails to comply with the provisions of Part X is liable to a fine under section 414. It has been suggested that a more effective and economical sanction would be provided if the contracts of an overseas company which was in default were made unenforceable, on the analogy of section 8 of the Registration of Business Names Act, 1916. We do not think it would be wise to extend this provision so as to enable parties contracting with a company to escape from their obligations on the technical ground that the company was in default over a matter which might have no relation to the contract.

516. The provisions of section 407 (1) (c) and of section 412 are designed to facilitate the service of process upon an overseas company. They only apply to companies which have established a place of business in Great Britain. Our attention has been drawn to certain defects in these provisions. If an overseas company fails to nominate a person authorised to accept service of process on its behalf, and then ceases to have an established place of business in Great Britain, there is no provision under the Act enabling a creditor to serve notice upon the company. We think section 412 should be extended to provide that in such a case process may be served at any place in Great Britain at which the company has had an established place of business within (say) the last three years. Another defect in the provisions can operate to the prejudice of an overseas company. Where such a company has nominated a representative to accept service on its behalf and then ceases to have an established place of busi-

ness in Great Britain, there is no provision enabling the company to revoke the authority it has given to its representative and, if he is prepared to accept service on its behalf, the company may be made amenable to the jurisdiction of our Courts for an indefinite period after it has ceased to have an established place of business in Great Britain. We think that an oversea company should be entitled to have the name of a representative so appointed removed from the register (say) three years after it has ceased to have an established place of business in Great Britain.

517. The jurisdiction of the Courts to wind up companies incorporated outside Great Britain is derived from section 399 and section 400 of the Act. The latter provision deals expressly with companies so incorporated, the former with "unregistered companies", a term which has been held to include companies incorporated outside Great Britain. The power thus vested in the Court is discretionary and it is only in highly exceptional cases that the Court would exercise it if a company could not be shown to have carried on business in Great Britain. Such cases, however, have arisen and may arise again and we should be reluctant to deprive the Court of the jurisdiction to deal with them; if there are assets of such a company in this country and there appears to be no other way of ensuring that those assets can be made available to the persons who appear to be entitled to them (whether as creditors or contributories), we think the Court should be free to order the company to be wound up. We think that there should be inserted in the Act an express provision to the effect that the presence in Great Britain of assets of a company incorporated outside Great Britain is sufficient to give the Court jurisdiction to wind up the company irrespective of whether it has had a place of business in Great Britain or has carried on business are so long as one or other of the conditions specified in section 399 (5) is satisfied.

518. It has been represented to us that in view of the wide construction that has been placed upon the provisions of section 399 (5) the provisions of section 400 are otiose and that the section should therefore be repealed. In view of the conclusions set out in the preceding paragraph, we regard the repeal or amendment of section 400 as a question of drafting and one on which we should therefore make no recommendations.

519. Section 410 requires every overseas company operating in this country to make out a balance sheet and profit and loss account (and, where appropriate, group accounts) in the form required in the case of a company within the meaning of the Act, subject to any exceptions prescribed by the Board of Trade. It has been pointed out that in practice the Board accepts accounts from such companies in the form required by their country of incorporation unless the latter is considered to be inadequate. It has been suggested that section 410 should accordingly be amended so that overseas companies would in future be required to file accounts in the form prescribed in their country of incorporation unless the Board of Trade required otherwise. It is said in favour of this change that it would have little practical effect in this country, since the Board of Trade almost invariably accept accounts made out in the manner prescribed in the country of incorporation, but that such a change in the form of requirement would make other countries ready to adopt

a similar form to the advantage of British companies operating abroad. On the other hand, if the Board of Trade insist, as we think they should, that every oversea company makes out adequate accounts, the new form of the requirement would impose upon the Board the invidious and embarrassing task of distinguishing explicitly those countries whose accounting provisions were, in the opinion of the Board, inadequate. We would therefore, on balance, recommend a change in the present form of the accounting requirements for oversea companies.

520. Our attention has been drawn to certain discrepancies between the provisions with respect to prospectuses relating to the securities of foreign companies and the corresponding provisions relating to the prospectuses of companies incorporated in Great Britain. Thus under section 417 (3) a form of application must be accompanied by a prospectus, whether an offer is being made to the public or not; whereas the corresponding provision, section 38 (3), does not apply to an application issued in connexion with an offer which is not made to the public. Section 417 (5) (b) does not exempt forms of application even where the form of application relates to shares or debentures which are quoted on a prescribed stock exchange, whereas the corresponding provision, section 38 (5) (b), does exempt application forms which are so issued. We can see no reason for these discrepancies and think that the provisions relating to prospectuses of foreign companies should be brought into line with those relating to British companies.

521. It has also been pointed out to us that section 423 (2), which provides that an offer to a person whose ordinary business is to buy or sell shares or debentures is not to be deemed an offer to the public for the purposes of Part X of the Act, has nothing corresponding to it in the provisions relating to offers made by British companies, and it has been suggested that the provisions should be made to apply in both cases or repealed. We do not agree with either of these suggestions; we think it would lead to confusion if the provisions in question were applied to offers made by British companies but we think they probably serve a useful purpose in relation to the prospectuses of foreign companies and have received no evidence that they have caused any harm.

522. Section 420 requires the copy of a prospectus of a foreign company, filed with the Registrar of Companies, to be certified by the chairman and two other directors of the company as having been approved by the managing body. Neither "chairman" nor "director" is a term which is necessarily appropriate to all foreign companies, and we suggest that the section should be amended to require certification by two members of the governing body or if the company has not yet been incorporated, of the proposed governing body and signature should be permitted through agents authorised in writing, as is permitted by section 41, the corresponding provision applying to British companies.

#### *Other matters*

523. Section 435 applies some important provisions of the Companies Act to certain bodies corporate not registered under the Act but incorporated in and having a place of business in Great Britain. Sub-section (2) exempts from the application of those provisions "any body

not formed for the purpose of carrying on a business which has for its object the acquisition of gain by the body or by the individual members thereof." We think this exemption might be extended to cover any body which although it carries on business which has for its object the acquisition of gain by the body is prohibited by its constitution from distributing income or any other property to its members, both while it is a going concern or in a winding up. In the chapter dealing with Loan Capital we have recommended that Part III of the Act (which relates to the registration of charges) should apply to the bodies corporate to which section 435 applies.

524. On the other hand, we think that any body to which section 435 and the provisions of the Act specified in the Fourteenth Schedule do apply should, like overseas companies, be required to furnish to the Registrar "a certified copy of the charter, statutes or memorandum and articles of the company or other instrument constituting or defining the constitution of the company".

525. We recommend that:

(a) section 412 should be extended to provide that, where an overseas company has ceased to have an established place of business in Great Britain and it is impossible to serve notice upon it because there is no representative willing to accept service, service may be effected at any place at which the company has had an established place of business within, say, the last three years;

(b) an overseas company which has ceased to have an established place of business in Great Britain, should at the end of, say, three years from cessation be entitled to have the name of any representative nominated by it for the purposes of section 407 removed from the register;

(c) there should be inserted in the Act a provision expressly empowering the Court to wind up a company incorporated out of Great Britain if there are assets of that company in Great Britain;

(d) section 417 (3) should be brought into line with section 38 (3) and section 417 (5) (b) with section 38 (5) (b);

(e) section 420 should be amended to require the copy of a prospectus delivered to the Registrar of Companies to be certified by two members or the governing body (or, if the company has not yet been incorporated, of the proposed governing body) and signature should be permitted through agents authorised in writing;

(f) section 435 (2) (b) should be extended to exempt any company which by its constitution is prohibited from distributing either income or any other property among its members, both while the company is a going concern or in a winding up

(g) a company to which section 435 and the provisions specified in the Fourteenth Schedule apply should be required to deliver to the Registrar of Companies for registration a certified copy of the charter, statutes or memorandum and articles or other instrument constituting or defining the constitution of the company.

## *Conclusion*

526. In conclusion we should place on record our appreciation of the invaluable assistance which we have received at all stages of our inquiry from Mr. P. E. Thornton, as Secretary and Mr. J. A. E. Davies as Assistant Secretary to the Committee, and also from their assistant Miss D. M. Leddra.

JENKINS.

F. R. ALTHAUS.

E. A. BINGEN.

L. BROWN\*.

GEORGE ERSKINE\*.

L. C. B. GOWER\*.

W. H. LAWSON\*.

J. A. LUMSDEN.

K. W. MACKINNON\*.

MARGOT NAYLOR\*.

GORDON RICHARDSON.

C. HILARY SCOTT.

RON SMITH\*.

WILLIAM WATSON.

P. E. THORNTON (*Secretary*).

J.A.E. DAVIES (*Assistant Secretary*).

30th May, 1962.

*\* Those members whose signatures are marked with an asterisk have signed the Report subject to Notes of Dissent which follow.*

## **NOTE OF DISSENT**

by Mr. I. Brown, Sir George Erskine and Professor L. C. B.  
Crower

### **SHARES WITH RESTRICTED OR NO VOTING RIGHTS**

1. As the Report states, there was a more marked division of opinion amongst our witnesses on the matter of equity shares with restricted or no voting rights than on any other. After a lengthy discussion in paragraphs 123 to 136 of Chapter IV (which, however, does not seem to us to give adequate weight to the arguments against non-voting shares) the Report fails to express any view on the merits or demerits of such shares and makes only two recommendations, namely, that all concerned should be exhorted to ensure that such shares are clearly designated and that all shareholders (whether or not they have votes) should be entitled to receive notices of general meetings and of chairman's statements. A further suggestion that all shareholders should be entitled to attend meetings is rejected on "grounds of administrative difficulties". Feeling, as we do, that the development of non-voting equity shares is undesirable both in principle and practice, we find ourselves unable to concur in the failure to make stronger recommendations for their control.

2. In our opinion the growth of non-voting and restricted-voting shares (a) strikes at the basic principle on which our Company Law is based (paragraph 3 below), (b) is inconsistent with the principles underlying our Report and the Reports of earlier Company Law Committees (paragraphs 4, 5 and 6) and (c) is undesirable (paragraphs 7 et seq.)

3. The business corporation is a device for enabling an expert body of directors to manage other people's property for them. Since these managers are looking after other people's money it is thought that they should not be totally free from any control or supervision and the obvious persons to exercise some control are the persons whose property is being managed. Hence the basic principle adopted by British Company Law (and,

indeed, by the laws of most countries) is that ultimate control over the directors should be exercised by the shareholders. This control cannot be exercised in detail and from day-to-day, but shareholders retain the ultimate sanction in that it is they who "hire and fire" the directorate.

When the directors own the majority of the equity they are free from outside control, but here they are managing what is, as to the major part, their own money. Hence the interests of the directors and the shareholders are unlikely to conflict, and self-interest should be a sufficient curb and spur (subject to certain legal rules to protect the minority against oppression). When, however, the directors have no financial stake in the prosperity of the company, or only a minority interest, the outside control operates,

4. Successive Company Law Amendment Committees have, in the words of our immediate predecessor, made it their major concern "to find means of making it easier for shareholders to exercise a more effective general control over the management of their companies", in the belief that the result will be "to strengthen the already high credit and reputation of British companies": Cohen Committee Report, paragraph 5. In pursuance of this aim the Cohen Committee recommended, among other reforms, what is now section 184 of the Companies Act, 1948, whereby the ultimate sanction vested in the shareholders (the right to dismiss the board) was greatly strengthened by enabling them to dismiss any director at any time by simple majority vote.

5. Many of our Committee's recommendations are expressly directed towards the same end of enhancing shareholder control. In particular, in Chapter III we recommend that certain activities should require the prior approval of resolutions in general meeting. These recommendations make sense only on the assumption that the general meeting will express the views of the majority of the equity shareholders and not merely the minority views of the directors themselves.

6. In recent years, however, control by shareholders has been stultified in two ways: firstly in a few oases by cross-holdings and circular holdings within a group of companies, and secondly by non-voting equity shares. The first method has already received the attention of the legislature and an attempt has been made to control it by section 27 of the Act. In our discussion of this section in paragraphs 151-155 of Chapter IV we recognise that it is improper for directors to maintain themselves indefinitely in office, against the wishes of the other shareholders. We also recognise that section 27 does not go far enough in preventing this mischief and we reject an extension of the section with reluctance and only because of the complexity and arbitrary nature of the provisions which would be necessary. Where the mischief can be easily prevented, for example by banning the exercise of votes on shares held on trust for the company, we recommend that this should be done: Chapter IV paragraphs 154 and 156 (b).

The second method of maintaining control by the existing directors, by utilising non-voting shares, is not as yet controlled in any way; it is only of recent years that it has

become a major issue. Today non-voting shares are the simplest and most straightforward method whereby directors can render themselves irremovable without their own consent, notwithstanding that they only own or control a fraction of the equity. This is different from cross-holdings and circular-holdings which may have grown up for legitimate business reasons and with no intention of stultifying shareholder control and section 184.

7. It is said that shareholder control is ineffective because of the indifference of shareholders. Everyone would probably agree that shareholders are apathetic while all goes well. But, while all goes well, there is no reason why they should not be apathetic; their intervention is required only when things go ill. No doubt it is true that the small individual shareholder has little power even then, but, as we point out in paragraph 106, the institutional investor has considerable influence; and even non-institutional shareholders are collectively powerful so long as

they have votes. It can hardly be doubted that the possibility that a take-over bidder will obtain control by acquiring these votes has caused directors to pay greater heed to the interests of shareholders.

8. It is also said that shareholder control is inefficient, since directors, as a class, know better what is good for business and for the shareholders than the shareholders themselves. In the normal case this is usually true. But if shareholder control is destroyed and nothing put in its place we have to go still further and say that business efficiency is best ensured by allowing the directors to function free from any outside control, except that of the Courts in the event of fraud or misfeasance, and by making themselves irremovable, without their own consent, however inefficient they may prove to be.

9. It is, admittedly, difficult to name actual examples where non-voting shares have already led to the prolongation of inefficient managements, but the development is relatively new and the testing time will come later. All one can say is that it appears to be generally agreed that takeover bids have on the whole served a useful economic purpose and led to a desirable re-deployment of resources, and that in most cases the new managers have proved more efficient than the old. We do not understand how one can at the same time favour take-over bids and countenance non-voting shares which are designed to frustrate take-overs. Some recent take-overs have been made in the face of opposition by the existing board and would not have been possible had the board been entrenched through the use of non-voting shares. There may have been some cases where an efficient management has been able, thanks to non-voting shares, to protect itself against an inefficient or unscrupulous raider, but there is even less evidence of this. Efficient directors who have treated their shareholders fairly and frankly should have little to fear from a raider. In any case, it goes too far to allow them to protect themselves against this remote risk by converting themselves into a self-perpetuating oligarchy.

10. The objections to non-voting shares are strongest in the case of publicly quoted companies, particularly with the current movement to encourage the spread of shareholdings amongst small private investors. Even here they may sometimes

be justified (perhaps, for example, in the case of the television programme companies where the original subscribers for the voting shares and subsequent transferees have to be approved by the Independent Television Authority).

In the case of public companies, non-voting equity shares are banned by legislation in South Africa and India and in many Continental countries. For many years the New York Stock Exchange has refused to list non-voting shares. The Australian Associated Stock Exchanges have recently done likewise; see their Official List Requirements dated 26th June 1961. The Rules of the London Stock Exchange provide that quoted Preference Shares must be afforded reasonable voting rights but, despite this, the Exchange has hitherto refused to apply the same rule to Ordinary Shares although it has expressed its dislike of non-voting shares.

11. If the British Stock Exchanges were prepared to refuse quotations for new issues of non-voting shares it might still be unnecessary to impose

legislative control. But, as it is, we think that legislation is called for to prevent the continued growth of such shares in the case of quoted companies. We would not think it necessary to provide for the compulsory enfranchisement of existing non-voting shares and, to avoid complications, we would be prepared to allow companies which already have non-voting shares to make further issues. The Stock Exchanges could be relied upon to ensure that this power was not abused, just as they would ensure that the legislative ban was not evaded by giving quotations for special types of securities designed to that end.

12. For these reasons we consider that the recommendations in paragraph 140 should be strengthened, and we recommend:

(a) that all equity shareholders, whether or not they have votes, should be entitled to attend, in person or by proxy, and to speak at all general meetings of their company;

(b) that there should be a prohibition on the granting of a quotation for non-voting and restricted voting equity shares (save in exceptional circumstances and subject to the approval of the Board of Trade) except as regards further issues of such shares for which a quotation had already been granted prior to the publication of our Report.

L. BROWN.

GEORGE ERSKINE.

L. C. B. GOWER.

## **NOTE OF DISSENT**

by Professor L. C. B. Gower, Mr. W. H. Lawson, Mr. K. W. Mackinnon, Q.C., Mrs. M. Naylot and Mr. Ron Smith

### **ACCOUNTS OF BANKS AND DISCOUNT COMPANY**

*(referred to in this note collectively as Banks)*

1. We dissent from the recommendation in paragraph 407 (a) that the existing exemptions of banks and discount houses should continue. We agree with our colleagues that it is essential that confidence in the banking system should be maintained but we are not convinced that it is necessary for this purpose for banks to withhold information about their operations from their shareholders and from the public generally - still less that it is necessary to withhold all the information that is at present withheld. We are not satisfied that all classes of banks need be treated alike and we believe that such exemptions as are shown to be necessary should not be granted in the Act, but by the Board of Trade exercising their powers under paragraph 25 of the Eighth Schedule which should be widened if necessary.

2. It is a basic requirement of the Companies Act that shareholders should be provided with a true and fair view of the state of their company's affairs and of its profit or loss and any resulting inconvenience must be accepted as the price of incorporation under the Act. It is wrong, in principle, that any exceptions should be made and, indeed, the Banks have not argued their case on grounds of principle but on expediency. Their case must, therefore, be examined with care and exemptions should be granted only from those requirements of the Act which are either unsuitable for banks or clearly contrary to the interests of shareholders and depositors.

3. One of the effects of the wide exemptions granted to the banks under the 1948 Act has been to freeze the published accounts of all banks in a rigid pattern. The form used has not been devised especially for banks but is an adaptation of

a form of accounting presentation which was widely used for public companies many years ago. It ignores the great changes in accounting practice which have taken place in the meantime and it is unlikely that it is the best form which could now be devised.

4. The arguments for and against the banks' case are set out in paragraphs 398 to 404 of the Report and need not be repeated here. The main defect in the present form of annual accounts is the absence of any true and fair statement of the profits of the business either year by year or over a period. Shareholders are thus prevented from making any intelligent criticism of the management of the company which in law they own and control, of an assessment of the value of their shareholdings.

5. Some of the banks in the United States of America publish full annual accounts and in this country some of the Acceptance Houses have

published their profit records when obtaining a Stock Exchange quotation for their shares. No harm seems to have resulted, it may be argued that conditions have been favourable and that publication of true results in more difficult times could be harmful. However, investment analysts already make their own estimates of the profits of the Clearing Banks and these are given wide publicity; we are doubtful whether, under modern conditions, it would be practicable for a particular bank or for the banks generally to conceal any serious weakness which had developed. It is arguable, therefore, that the exemptions might, when put to the test, prove unless for the purpose for which they are alleged to be needed. That, however, is not an essential link in our main argument which is that, on the basis of the evidence before us, many of the exemptions now granted to the banks are unnecessary except, perhaps, for banks operating mainly overseas.

6. We draw a distinction between banks which are operating overseas and those whose main business is in the United Kingdom. The former may be acting under laws which, as regards accounting requirements, may be quite different from our own and they are in competition with banks operating under those laws. They are subject to political and other risks to which the domestic banks are not exposed.

7. The banks claim that the present exemptions stand together as a coherent whole and that if one of them were withdrawn the rest would be of little or no value. Thus, their inner reserves must remain secret in order that drafts may be made on them to meet exceptional losses without disclosure. Annual profits must be concealed in order that transfers may be made from them to build up the inner reserves. Taxation cannot be disclosed since this would indicate the real level of annual profits; and so on.

8. We have not been convinced that any of the exemptions are really necessary to sustain public confidence in the banks. But, if some concealment is to be permitted, we think that certain exemptions are more objectionable (from the point of view of shareholders) and less useful (from the point of view of maintaining public confidence) than others, and that it would in fact be practicable to maintain some exemptions while withdrawing others.

9. Let us first consider the continued existence of the inner reserves themselves. All companies are free to make, without disclosure, such provisions as are reasonably necessary for diminution in the value of their current assets. Thus banks would not presumably need to rely on their special exemptions to make such undisclosed provisions in respect of their debts and investments. We accept that the banks may, in addition, require to make further provision for contingencies, beyond those which other businesses would normally regard as reasonably necessary. Their inner and published reserves together provide this additional security. It is clearly in the interests of depositors and shareholders that the banks should make prudent provision against potential losses. It would be useful for the shareholders to know the total of all the reserves because they form part of the working capital of the bank but we do not think this information is essential for shareholders or that it would matter very much if a

part of the reserves remain, as at present, undisclosed in their balance sheets. It is some of the further exemptions which are alleged to be necessary to protect this one - particularly the exemption from disclosing a true and fair view of the profits - which seem to us objectionable.

10. The most important part of the banks' case is that inner reserves are needed because the banks are exposed to special risks and that the movements which can take place in the value of their investments and the losses which can be made in lending can be out of proportion to the profits of a single year. It is argued that disclosure of these movements could cause lack of confidence and even a run on a bank. There is little evidence about the kind of losses which have been charged against the inner contingency reserves but we have been told that they were used to meet exceptional losses on investments a few years ago and, presumably, they have also been used occasionally to meet exceptionally large losses on debts. While we agree that it might be undesirable to disclose the amount of potential losses which, at any balance sheet date, were regarded as covered by the contingency reserves, we are not satisfied that any real harm would result from disclosing realised losses after they have been incurred. Losses on investments can be explained and exceptional losses on debts may well be evident from the action of the bank in appointing receivers or from an examination of the accounts of the businesses concerned, Information about losses is essential to enable shareholders to judge the results achieved by a bank over a period and we think it should be disclosed. If, however, it is thought that some concession is required to provide for these wholly exceptional circumstances, that might, perhaps, take the form of giving a restricted power to the directors to defer disclosure for a stated period (provided the amount of the loss was covered from a contingency reserve). This concession should not, however, be made a reason for producing year after year statements of profits which are neither true nor fair.

11. We have no information as to how frequently the contingency reserves are used for meeting losses and the practice may vary in the different banks. The formula used for describing the published profit is ambiguous and it is not possible to ascertain from it whether in any year the amounts added to inner reserves have been more or less than the amounts withdrawn from them. The law at present permit inner

reserves to be used to increase the profit of a poor year or to turn a loss into a profit. The banks agreed that the description of the profit should be altered in such circumstances but they did not agree that the actual amount transferred to profits should be disclosed. Sir Oliver Franks said he thought that such transfers may have been made in the years 1931, 1932 and 1933. The books, in their evidence, have quite rightly put first the interests of depositors. We think it would be quite wrong for deposits to be accepted on the basis of accounts which showed a bank to be more prosperous than it really was but the law at present would permit this to be done.

12. We think that, in future, amounts added to inner reserves from profits should be disclosed as this is essential for a true and fair view of the profit or loss for the year. The banks' arguments against disclosure are that it would be impracticable without disclosing existing reserves and

the reason why it is considered that such reserves are inadequate. We do not agree with this. It is true that a shareholder might be able, after existing inner reserves have become exhausted, to make his own calculation of the probable amount of the inner contingency reserves, but we do not think that would matter. Nor do we think it would be necessary to explain why existing reserves are regarded as inadequate: we are confident that shareholders would appreciate the need for prudence and an increase in the size of the banks' commitments would be a sufficient reason for increasing the contingency reserves.

13. It seems to us from the published accounts of the banks that undisclosed transfers to inner reserves are now being made not so much to strengthen those reserves (from which indeed transfers have been made to published reserves) as to reduce consistently the real profits of the banks. We can see nothing in the evidence to justify the continued concealment of the true level of profits. Sir Oliver Franks, as spokesman for the Committee of London Clearing Bankers, said in evidence:

"For some years we are apt to have quite poor profits and then for some years we have quite good profits. These really flow from what the decisions of the Authorities may be about the level of interest rates and so forth; when interest rates are very low, things are harder; when interest rates are high, things are easier. But I do not want to lay great stress on the because I think that could be explained either to the shareholders or to the public by giving them a reasonable account of what the situation was."

Again, in a reply to a question as to whether, when profits were high, shareholders might ask for higher dividends. Sir Oliver Franks replied:

"If I may I am going to assume for the purposes of this answer that what the banks in fact do in relation to their dividends is sensible and defensible. I think it is perfectly true that in relation to a good year the amount of dividend that might be paid would appear to be rather small and I would expect in the case of my own bank to be cross-questioned about it by the

shareholders on why more was not being done for more, and it would be my business to try to explain that the view which the bank had to take was not exhausted in the results of twelve months, that it had to look before and after; before in relation to the commitments that it had undertaken and after in relation to the run of the years an average. It might or might not be difficult to convince the pertinacious shareholder, but I do not think that I would want to stand on that difficulty very heavily as a major reason for the consideration of the preservation of hidden reserves. If I had to cope with that one, I would. It might be not altogether easy, but it would have to be done."

The Scottish banks have indicated in their evidence that it is important that normal earnings should not be distorted by special circumstances which they mention. At the present time, however, normal earnings are not disclosed either annually or over a period.

14. We appreciate that the suggestions we have made for the disclosure of profits would, if accepted, result in much larger differences between the disclosed profits of one year and another. We have no means of knowing how large these differences are likely to be or whether the profits of some banks vary more than others. A year is an inconveniently short accounting period for many businesses and it could be particularly inconvenient for banks because of variations in losses on debts and investments

as well as changes in interest rates. We are encouraged by the remarks of Sir Oliver Franks to believe that these differences could be explained without undue embarrassment. On the other hand, it is possible that a case could be made out for the banks publishing a true and fair statement of profits at intervals of three or five years instead of at annual intervals as required for other companies. It would, in our view, be far better to have a true and fair statement of profits once in five years than unfair statements each year. If this suggestion were adopted the banks should continue to be required to publish a balance sheet each year, together with such interim statement of profits as the directors decide.

In short, we think that, on the evidence before us, the case for the banks disclosing their real profits either annually or at longer intervals of time is extremely strong and it is this information above all else which is important to the shareholder.

15. We think that the banks should show their profits before and after taxation which means that they would have to disclose the amount of taxation charged against the profits. We recognise that the provisions to be made for bad and doubtful debts may substantially exceed the amounts allowed in any year for tax purposes, the position being reversed when the loss is incurred, If the banks wished to adjust this situation through a tax equalisation account, disclosure of the amount of that account and of the movements on it should not be required. The creation of a tax equalisation account would result in the taxation charge to be shown in the accounts being appropriate to the disclosed profit for the year; transfers to inner contingency reserves would, of course, be made out of net profits after tax. The creation of a tax equalisation account should not, however, be made compulsory.

16. There are a number of other exemptions which seem unnecessary. For example, it is difficult to see what harm could be done by the banks disclosing the market value of their investments. The banks have agreed that the market value of investments should be shown when it is below cost but not when it is above cost. The argument used is that disclosure would reveal a paper profit which might be fugitive and

unreliable. This is true wherever the market value of investments is required by law to be shown and we see no reason to exempt the banks from this general requirement. It also seems to us that no harm could be done by the banks disclosing the cost of their premises and the depreciation charged thereon.

17. We have indicated above the reasons why we believe that the accounts of the banks should be looked at afresh. It would clearly be undesirable to produce any detailed scheme without examining the accounts themselves. The Committee, whose evidence was to be published, understandably did not ask the banks to submit their full accounts. We think, however, that they should be invited to submit their accounts, in confidence, to the Board of Trade. The information, which might cover a period of ten or twenty years, should include statements showing (a) the amounts credits to the inner contingency account and the sources from which they came, (b) the amounts debited to the accounts, the nature of such items and the reasons why they were not charged against profit and loss account or open reserves. An attempt should be made to

reconstruct the accounts of some of the banks in order to show how they might have appeared had the exemptions been limited in the way suggested above.

18. We recommend that:

(a) the present exemptions contained in the Eighth Schedule of the 1948 Act should be withdrawn;

(b) the Board of Trade should exercise their powers under paragraph 25 of the Eighth Schedule (widened, if necessary) to grant exemptions;

(c) the exemptions should not extend beyond what the Board of Trade are satisfied to be necessary in order to preserve public confidence; we hope that the Board when considering what is necessary for this purpose, will have before them information from the banks on the lines suggested in paragraph 17 above and that they will take account of our observations.

L. C. B. GOWER.

W. H. LAWSON.

K. W. MACKINNON.

MAROOT NAYLOP.

RON SMITH.

## **APPENDIX A**

### **MEMORANDUM ISSUED TO CERTAIN ORGANISATIONS AND INDIVIDUALS**

A Committee, under the chairmanship of Lord Jenkins, has been appointed by the President of the Board of Trade with the following terms of reference:

"To review and report upon the provisions and working of the Companies Act, 1948, the Prevention of Fraud (Investments) Act, 1958, except in so far as it relates to industrial and provident societies and building societies, and the Registration of Business Names Act, 1916, as amended; to consider in the light of modern conditions and practices, including the practice of take-over bids, what should be the duties of direction and the rights of shareholders; and generally to recommend what changes in the law are desirable."

The Committee would be glad to have your views (which may be published in due course) on these matters. A list of subjects, on which your views would be welcomed, is annexed. The Committee will, of course, also be glad to have your views on any other matters within their terms of reference which are not specified in the annex, while, on the other hand they recognise that you may well wish to give evidence on only a few of the subjects listed.

## **ANNEX**

### **1. Incorporation of companies - Memoranda of Association**

(a) Requirements as to minimum number of members, and other conditions of incorporation.

(b) Limitation of objects to those stated in the Memorandum; obsolescence of ultra vires rule in view of universality of modern objects clauses; effect of that rule as between a company or its directors and third parties, and as between a company and its directors. The present method of altering objects.

(c) The company as a legal entity distinct from its members - "one-man" companies.

(d) Shares of no par value. (Bearing in mind the Government's announced intention to implement the recommendations of the Committee on Shares of No Par Value. Cmd. 9112, 1954.)

## **2. Prohibition of Partnerships with more than 20 Members**

(Section 434 of Companies Act, 1948).

## **3. Classification of Companies**

(a) Nature and merits of distinction between public and private companies; adequacy of restrictions imposed on the latter.

(b) Nature and merits of distinction between exempt and non-exempt private companies (Sections 127, 129 of Companies Act, 1948).

(c) Unlimited companies and companies limited by guarantee.

## **4. Donations by Companies for Charitable and Political Purposes**



## **5. Exercise of Powers of Companies by Directors and Degree of Control Retained by Shareholders**

The following are suggested as some of the matters calling for consideration under this general heading:

- (a) Fundamental changes in company's activities.
- (b) Disposal of undertaking and assets.
- (c) Issue of shares.
- (d) Borrowing money and charging property.
- (e) Lending money otherwise than in the ordinary course of business.

## **6. Directors' Duties**

- (a) Should their duties be stricter and more clearly defined, and if so, in what respects?
- (b) Are Directors generally aware of the legal duties arising from their fiduciary position?
- (c) Directors' and officers' dealings in their own companies' shares.
- (d) Disclosure of Directors' interests.

(e) Should bodies corporate be allowed to be Directors?

## **7. Shares with Restricted or no Voting Rights**

## **8. The Protection of Minorities**

Adequacy of existing remedies. Winding up under the "just and equitable" rule (Section 225 (2) of Companies Act, 1948); the remedy afforded by Section 210.

## **9. Protection of Special Classes of Shares**

Modification of class rights (Section 72 of Companies Act, 1948) - getting rid of preference shares by winding up or return of capital.

## **10. Board of Trade Powers to Appoint Inspectors**

## **11. Disclosure of Ownership and Control**

(a) Nominee shareholders and debenture holders (including nominee holding companies).

(b) Control through nominee Directors.

## **12. Share Transfer and Registration Procedure**

## **13. Multiplicity of Directorships held by One Individual**

#### **14. Practice of Carrying on Business through Associated and Subsidiary Companies**

#### **15. Loan Capital**

- (a) Debentures and Debenture Stock.
- (b) Trust Deeds - Duties of Trustees and Receivers.
- (c) Registration of Charges.

#### **16. Take-over Bids**

- (a) Procedure.
- (b) Securing disclosure of information on which shareholders can form an opinion.
- (c) Functions of Directors.

(d) Disclosure of identity of bidder.

(e) The financing of such transactions.

(f) Disclosure of Directors' interests - compensation for loss of office (Sections 191-194 of Companies Act, 1948).

(g) Application of provisions regarding compulsory acquisition of shares of dissenting minority (Section 209 of Companies Act, 1948).

#### **17. Prospectuses---Statements In Lieu of Prospectuses - Offers for Sale - Issues of Shares to Existing Shareholders**

(a) Adequacy of protection afforded to investors by existing law.

(b) Usefulness and necessity of the existing provisions.

(c) Certificates of exemption (Section 39 of Companies Act, 1948).

#### **18. Control over Business of Dealing in Securities**

#### **19. Unit Trusts and "Open End Mutual Funds"**

#### **20. Reduction of Capital and Purchase by a Company of its own Shares**

#### **21. Accounts**

Do the accounts require the disclosure of sufficient information about the financial position of the company, including its subsidiaries and associated companies? Are all the existing provisions necessary and useful in present-day conditions?

In particular evidence would be welcome on the following points:

- (a) Revaluation of fixed assets and use of any resulting surplus.
- (b) Share premium account.
- (c) Use of pre-acquisition profits of subsidiaries.
- (d) Description of reserves.
- (e) Definition of profits.
- (f) Exemption of banks, assurance, shipping companies from some of the accounting provisions of the Companies Act, 1948.

## **22. Audit**

- (a) Qualifications and appointment of auditors.
- (b) Duties and responsibilities of auditors.

(c) Exemption of "exempt private companies" from the provisions of 161 of the Companies Act, 1948.

## **23. Provisions as to Returns**

## **24. Company and Business Names**

Effectiveness of present provisions (see Sections 17 to 19 of Companies Act, 1948 and the Registration of Business Names Act, 1916); similarity of remain; misleading names.

## **25. Foreign Companies**

## **26. Internal Management and Administration**

In particular

(a) Annual and other General Meetings.

(b) Mode of passing extraordinary and special resolutions.

(c) Securing proper disclosure of information in circulars seeking proxy votes.

(d) Exercise of voting rights in cases of interlocking shareholdings, unit trusts, and in other special cases, e.g. by trustees of pension and welfare funds for employees in relation to shares held by such funds in the employer or any associated company.

## **27. Winding Up**

## **28. Problems of Administration and Enforcement of the Law**

In particular, are any difficulties caused by provisions which appear obsolete or inappropriate in modern conditions?

## **29. Any other Matters within the Terms of Reference**

## **APPENDIX B**

### **ORGANISATIONS AND INDIVIDUALS WHO GAVE ORAL EVIDENCE BEFORE THE COMMITTEE**

The Accepting Houses Committee and The Issuing Houses Association (represented by Sir Edward I. Reid, Bt., O.B.E., Mr. H. I. S. French, O. B. E., Mr. K. C. Barrington and Mr. L. W. Hatch).

The Association of British Chambers of Commerce (represented by Mr. S. R. Hogs, D.S.O., M.C., Mr. D. B. Tracey, Mr. W. J. Luxton and Mr. H. Crump).

The Association of Certified and Corporate Accountants (represented by Mr. I.E. Harris, Mr. L H. Hills, Mr. P. Phillips, Mr. N. R. Tribble and Mr. I. R. Sparey).

The Association of International Accountants Limited (represented by Mr. E. P. Hubbard, Mr. K. Mines, Mr. S. W. Barter, M.P., and Mr. C. E. Taylor).

The Association of Investment Trusts (represented by Sir Edwin Herbert, K.B.E., Mr. G. L. C. Touche and Mr. W. S. Gaminell).

The Association of Stock and Share Dealers (represented by Mr. P.O. Smith and Mr. W. A. Tuckwell).

The Association of Unit Trust Managers (represented by Sir Oscar Hobson Mr. E. D. L. du Cann, M.P., Mr. G. H. Fletcher, Mr. O. P. Stutchbury and Mr. W. G. N. Miller).

The British Insurance Association (represented by Mr. H. A. Walters, Mr. J. B. H. Pegler, Mr. J. F. Bunford, Mr. H. J. Henderson Smith, Mr. I. W. Kempe and Mr. R. C. W. Bardell).

The Board of Trade (represented by Sir Richard Powell, K.C.B., K.B.E., C.M.G., Mr. I. Leckie, C.B., Mr. R. I. W. Stacy, C.B., Mr. E. W. Dean, C.B.E., Mr. P. I. Mante, C.M.G., Mr. H. Osborne, Mr. L. M. Clarke, C.B.E., Mr. W. B. Langford, M.B.E.).

The British Overseas Banks Association (represented by Mr. R. F. Williams, Mr. W. G. Pullen, Mr. R. V. Low, Mr. S. K. Brooke and Mr. R. G. Dyson).

The Chartered Institute of Secretaries (represented by Mr. E. G. Hardman, Mr. W. F. Talbot, Mr. J. F. Phillips, O.B.E., and Mr. G. N. Gabell).

The Committee of London Clearing Bankers (represented by The Rt. Hon. Sir Oliver Franks, G.C.M.G., K.C.B., C.B.E., Mr. F. Keighley, Mr. R. G. Thornton and Mr. H. B. Lawson, M.C.).

The Committee of Scottish Bank General Managers (represented by Mr. W. R. Ballantyne and Mr. R. D. Fairbairn).

The Council of Associated Stock Exchanges (represented by Mr. C.T. Ockleston and Mr. A. Owen).

The Council of Scottish Chambers of Commerce (represented by Sir Robert A. Maclean, Mr. A.M. Hodge, G.C., V.R.D., and Mr. M. Niell).

Courtaulds Ltd. (represented by Mr. H. R. Mathys, Mr. H. L. Light and Mr. J. M. Edwards).

The Economist (represented by Mr. R. E. Bird, Mr. G. Lee and Mr. F. Hirsch).

The Faculty of Advocates (represented by Mr. I. H. Shearer, Q.C., and Mr. J. P. H. Mackay).

The Federation of British Industries (represented by Sir Nutcombe Hume, K.B.E., M.C., Mr. Hugh Saunders, Mr. A. A. Sherifield and Mr. C. P. Cottis).

The General Council of British Shipping (represented by Mr. A. F. Hull, Mr. C. W. Aston, Sir John Brocklebank, Bt., Mr. F. Charlton, Mr. J. A. Mann, Mr. H. E. Gorick, C.B.E., and Mr. Roy Hill).

The General Council of the Bar (represented by Mr. P. J. Sykes and Mr. T. D. D. Divine).

Guest, Keen and Nettlefolds Limited (represented by Mr. W. A. Nicol, Mr. W. W. Fea and Mr. G. T. Hughes).

The Institute of Actuaries (represented by Mr. J. H. Gunlake, C.B.E., Mr. F. M. Redington and Mr. R. E. Beard, M.B.E.).

The Institute of Chartered Accountants in England and Wales (represented by Mr. Henry A. Benson, C.B.E., Sir Thomas Robson, M.B.E., Mr. Paul F. Granger and Mr. F. M. Wilkinson).

The Institute of Chartered Accountants of Scotland (represented by Mr. T. Lister, Mr. G. D. H. Dewar and Mr. E. H. V. McDougall).

The Institute of Directors (represented by Mr. Alfred Read, C.B.E., Mr. P. L. Fleming, Mr. J. Godfrey, Mr. A. E. S. Menzies and Mr. A. T. Purse).

The Law Society (represented by Sir Charles Norton, M.B.E., M.C., Mr. K. D. Cole, Mr. G. F. H. Dennehy, Mr. N. F. Henlé, Mr. A.M. Welsford and Mr. D. D. Mackintosh).

The Law Society of Scotland (represented by Mr. i. Sutherland, Mr. W. A. Cook, Mr. G. K. V. Clarke and Mr. R. B. Laurie).

John Lewis Partnership Limited (represented by Mr. O. B. Miller and Mr. S. A. Wetherfield, O.B.E.).

J. Lyons and Company Limited (represented by Mr. I. M. Gluckstein and Mr. H. E. Lofthouse).

The National Association of Trade Protection Societies (represented by Mr. E. C. Astin, Mr. C. G. Lamb, Mr. W. Norman Peet and Mr. C. McNeil Greig, M.C.).

The National Chamber of Trade (represented by Mr. H. Austral Ryley, Mr. P. J. Mortlock and Mr. J. W. Stevenson).

The Registrar of the Companies Court (Mr. Registrar Berkeley).

The Society of Investment Analysts Limited (represented by Sir Henry Warner, Bt., and Mr. P. W. Freeman).

The Stock Exchange, London (represented by the Lord Ritchie of Dundee, Mr. J. A. Hunter, M.B.E., T.D., Mr. R. C. Quirk, O.B.E., Mr. W. D. Walker, O.B.E., Mr. C. D. Morley and Mr. W. S. Wareham).

The Trade Indemnity Company Limited (represented by Mr. S. E. Phillips and Mr. R. C. Steven).

The Trades Union Congress (represented by Mr. H. Douglass, Mr. George Woodcock, C.B.E., Mr. L. Murray and Mr. N. Ferguson).

Mr. M. F. Cohen of the United States Securities and Exchange Commission.

Professor L. Loss of Harvard University.

Mr. H. S. Morgan, Mr. J. M. Young and Mr. F. A. Petito of Morgan Stanley & Co., New York.

Mr. G. A. Brownell and Mr. F. A. O. Schwarz of Davis Polk  
Wardwell Sunderland and Kiendl, New York.

Mr. C. D. McDaniel of Arthur Andersen & Co.

Professor W. T. Baxter.

Mr. Charles Clore.

Mr. H. C. Edey.

Mr. S. I. Fairbairn.

Mr. E. S. Fay, Q.C.

Professor E. V. Morgan.

Mr. Gordon Newton.

The Lord Piercy, C.B.E.

Mr. L. Sainer.

Professor B. Tew.

Mr. Harold Wincott.

(32240)    Wt. 115-4063    K200    6/62    St.S.