LEWIS SILKIN

Share buy backs - what's the fuss?

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Introduction

When a company is planning a share buy back (or purchase of its own shares) it's time to be careful.

This note explains why you need to be careful, and summarises the company law issues that must be addressed in advance before the company enters into any commitments.

As more companies are incentivising employees by issuing shares directly to them and a private company would usually want to sever all relations with a departing employee, buy backs are becoming more common.

This note focuses on buy backs by English incorporated private companies, particularly from departing employees.

What's behind all this fuss?

The general rule is that a company must not purchase its own shares save in certain limited circumstances. Those limited circumstances involve the company meeting certain conditions and completing certain procedures.

Enshrined in company law is the principle of maintenance of capital which this general rule reflects. Once a shareholder has subscribed for shares issued to him by the company, the company's share capital represented by those shares must be preserved. Strict rules apply when a company wants to reverse that step.

Those strict rules do not apply when a shareholder transfers his shares in the company to another (although transfers of shares may be subject to other controls). A share transfer may not be a practical option for a departing employee if, for example, the other shareholders cannot, or do not wish to, buy his shares.

What are the consequences of ignoring the company law requirements on buy backs?

The consequences of not dealing with the conditions and procedures for buy backs are potentially serious and undesirable for both the company/employer and the shareholder/employee.

There are criminal sanctions, including:

- unlimited fines on the company and its directors; and
- imprisonment for the directors for up to two years.

And civil sanctions: the buy back agreement is void. The selling employee could be required to pay the cash consideration back to the company, and any restrictive covenants imposed on him under the agreement could fall away.

Why can't a company just pay cash for its shares whenever it wants to?

The conditions and procedures for a share buy back are designed to protect the company's creditors and its other shareholders:

- The creditors want some protection from the company becoming unable to pay its debts to them.
- The other shareholders want to ensure that they are being treated fairly as against the shareholder who is being bought out.

What are the company law conditions and procedures?

The following are the conditions and procedures for the most common circumstances that we come across in practice:

- The shares must be fully paid and the company must pay for the shares out of its distributable profits.

  The company must have made profits, which it hasn't already distributed, for example by paying a dividend. And that's after deducting any losses it has made in the past.

  The company would need to consult its own accountants or auditors to assess the amount of its distributable profits that are available to use in this way.

  It must also have the cash to pay for the shares on the purchase.

  This condition is designed primarily to protect the company's creditors.

- The company must obtain authorisation from its shareholders, by shareholders' resolution, either before the buy back agreement is entered into, or the agreement must be conditional on that authorisation being obtained.

  So if the termination arrangements with a departing employee include a share buy back, the buy back provisions (which could be included in the settlement agreement) must be conditional on the necessary shareholder authorisation first being obtained.

  This procedure is designed to protect the company's other shareholders.

  These are not the only conditions and procedures that may be applicable.

  There are other ways in which the company could be allowed to finance the purchase and obtain authorisation.

Why include a share buy back in the termination arrangements with a departing employee?

It is almost impossible to force a shareholder to give up his shares. And the shareholder cannot force the company or the other shareholders to buy his shares from him.

The settlement agreement, reflecting the employee's termination arrangements, gives both the company and the employee a negotiating opportunity to come to a mutually beneficial agreement for the buy back. The company gains by severing all relations with him and the employee gains by receiving an additional payment on his departure.

"Good/bad leaver" provisions

The company may already have in place arrangements under which the employee is obliged to offer up his shares on termination of his employment; such as "Good/bad leaver" provisions in the company's articles of association or its shareholders' agreement.

Those pre-existing arrangements are helpful in that they impose on the employee the obligation to sell his shares on his departure. But if it's the company, and not the other shareholders, buying them, the conditions and procedures mentioned above need to be addressed. For example, has the company sufficient distributable profits, and cash, to pay for the shares? Has the company obtained shareholder authorisation and is that authorisation still valid?

To sum up:

- If a departing employee has shares which the employing company is buying back from him, the company law conditions and procedures must be addressed before the wording of the settlement agreement is finalised.
- Doing so protects the company, its directors and the departing employee from the potentially serious civil and criminal consequences if the company law requirements are not met.
- The company law provisions are not arbitrary. They are there to protect creditors and other shareholders.

We would be very happy to discuss with you in more detail the conditions and procedures that would be relevant to your company and whether any other conditions and procedures would be more appropriate or could help to streamline the process.

The tax consequences would also need to be considered in advance. We would be pleased to advise on those aspects as well.

For further information on this subject please contact:

Nicola Mallett
Practice Development Lawyer
T + 44 (0) 20 7074 8082
nicola.mallett@lewissilkin.com

LEWIS SILKIN

5 Chancery Lane – Clifford's Inn
London EC4A 1BL
DX 182 Chancery Lane
T +44 (0)20 7074 8000
www.lewissilkin.com

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