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Bernard McCabe

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The Desirability of a Share Buy-Back Power

Abstract
The debate as to be desirability of allowing companies to purchase their own shares has raged intermittently for decades and has been the subject of many inquiries, reports and commissions - both here and overseas. The debate appeared to be concluded in 1989 when amendments to the Companies Act (Cth) 1981 made provision for a repurchase (or 'buy-back') power. The 1989 amendments incorporated a number of restrictions which were designed to guard against misuse of the power, while affording adequate protection to creditors. These amendments have subsequently been included in the new Corporations Law.

The prospect of substantial ongoing reform to the Corporations Law has reopened the debate. It is the object of this paper to contribute to that debate by arguing against a retention of a repurchase power in the new legislation.

Keywords
share, repurchase, buy-back, corporate law

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Comments and Notes

THE DESIRABILITY OF A SHARE BUY-BACK POWER

by
Bernard McCabe
BA, LLB
Supreme Court of Queensland and New South Wales
Solicitor , Bowdens Solicitors

Introduction

The debate as to be desirability of allowing companies to purchase their own shares has raged intermittently for decades and has been the subject of many inquiries, reports and commissions - both here and overseas. The debate appeared to be concluded in 1989 when amendments to the *Companies Act* (Cth) 1981 made provision for a repurchase (or 'buy-back') power. The 1989 amendments incorporated a number of restrictions which were designed to guard against misuse of the power, while affording adequate protection to creditors. These amendments have subsequently been included in the new *Corporations Law.*

The prospect of substantial ongoing reform to the *Corporations Law* has re-opened the debate. It is the object of this paper to contribute to that debate by arguing against a retention of a repurchase power in the new legislation.

Part One of this paper will consider the argument that the prohibition on repurchases is justified by inference from the general scheme of the companies legislation and from corporate theory, with a view to the object of creditor protection.

Part Two considers the arguments for and against buy-backs in particular circumstances. Special consideration is given to the implications of a buy-back power for the market for corporate control.

Part Three examines the question of 'proper purposes'. Consideration is given to the legitimacy of the objects of a repurchase power. The issues of corporate social responsibility are also briefly traversed.

Part 1

Limited liability and creditor protection

Prior to the mid 19th century, a company's purchase of its own shares was thought to be an unremarkable process. With the development of the concept of limited liability, however, the arguments against the continued existence of the power began to grow in force.[1]

The prohibition on share repurchases was finally cemented into the common law in *Trevor v Whithworth*.[2] The prohibition was subsequently enacted in companies legislation in England and thereafter in the various Commonwealth countries, including Australia. What was the rationale behind the Lord's decision?

In *Trevor v Whitworth*,[3] the Lords considered the provisions of the *Joint Stock Companies Act* 1867 and concluded, by inference, that the legislature could not have intended that buy-backs be allowed.

The Act included two provisions of particular interest to the Lords. Firstly, there was a requirement that the company should specify its nominal capital.[4] Secondly, the Act provided for a comprehensive procedure for reducing 'capital' - the assets of the company.[5]

From this, the Lords concluded - not unreasonably - that the legislature was obviously concerned that the capital of companies should not be reduced by distribution except in the manner set out in the legislation, which required court approval. At 437-8 Lord Macnaghten said:

> When Parliament sanctions the doing of a thing under certain conditions and with certain restrictions, it must be taken that the thing is prohibited unless the prescribed conditions and restrictions are observed.

The court held that buy-backs were a means of distributing capital to shareholders without having to comply with the formal requirements as to reduction to capital. The Lords noted that the legislature would not have gone to the trouble of incorporating safeguards for capital reductions if it has intended that the formal requirements could be avoided by so simple a device as a buy-back.[6]

It is interesting to note that our modern companies legislation, the Corporations Law, contains similar provisions considered to those by the Lords in *Trevor v Whitworth*.[7]

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1 Magner E S 'Repurchase Redemption and the Maintenance of Capital' in Austin R P, Vann R (eds) *'The Law of Public Company Finance'* Sydney 1986 (herein after cited as 'Austin & Vann').

2 (1887) 12 App Cas 409.

3 Above.

4 Found at Section 8 *Companies Act* 1862.

5 Magner E S 'The Power of a Company to Purchase its own Shares: A Comparative Approach' (1984) 2 C & SLJ 79 (herein after cited as 'Magner').

6 *Trevor v Whitworth* above at 416 per Lord Herschell.

Section 117(i)(b) of the Law provides that a company must specify the amount of share capital with which it proposes to be registered, and requires that the capital be divided into shares of a fixed amount. Section 195 goes on to establish a formal procedure to be followed in order to reduce capital. This procedure incorporates safeguards such as judicial scrutiny. The continued existence of the provisions (they were most recently re-enacted in 1991) tends to suggest that the legislature still regards the doctrine of capital maintenance as being of fundamental importance and that the creation of a buy-back power would be a serious departure from the underlying legislative scheme which is strongly biased towards preserving capital.

The capital maintenance doctrine which the Lords recognised in *Trevor v Whitworth* was borne out of a concern for the position of creditors[8] in the wake of the development of the concept of limited liability. Creditors were, in effect, generally prevented from having recourse to the company's shareholders in the event that the company could not pay its own debts. Creditors were forced to rely exclusively on the assets - the capital - of the company for repayment. It was thus of fundamental importance to creditors that that asset base be preserved as far as possible.[9]

Shareholders, in turn, agreed to subordinate their own claims for return of their equity investment to the claims of the creditors. Giving priority to creditors in the return of capital that resulted in winding-up of the company was the quid pro quo for the privileges of limited liability.[10]

Share repurchases were viewed as an attempt to subvert the order of priorities that has been established to compensate creditors for the recognition of limited liability. An unfettered repurchase power would allow shareholders to exit the company with their money prior to winding-up, leaving creditors with an ever diminishing security.[11]

The courts and thereafter the legislature recognised that capital reduction was inconsistent with the concept of limited liability.[12] The only exception permitted to the doctrine was carefully controlled reductions under court supervision, the equivalent procedure to that provided for under Section 195 of the *Corporations Law*.[13]

It is submitted that calls for a repurchase power come as a result of having lost sight of the essential terms of the bargain between shareholders and creditors which allows for limited liability. It is the contention of this paper that share repurchases are inheritently subversive of creditors' interests.

Proponents of the buy-back power point to certain safeguards that can be

7 Above.

8 Companies and Securities Law Review Committee Discussion Paper No 5 June 1986 *'A Company's Purchase of its own Shares'* (herein after cited as 'CSLRC').

9 Hribar Z 'A Guide to Company Law' (3rd ed) Sydney 1989 at 195.

10 *Trevor v Whitworth* above at 433 per Lord Macnaghten.

11 Austin & Vann above at 176.

12 *Trevor v Whitworth* above at 416 per Lord Herschell.

13 CSLRC above at 8.

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adopted with a view to minimising the risk that the creditors' security will be diminished. They cite the requirement typically found in companies legislation that repurchases must be made wholly or partly out of profits. The Australian legislation, for example, provides at Section 206 PD[14] that any premium paid on the par value of the share must be recovered from the share premium account, and from profits.[15] In those circumstances, they argue, the capital maintenance doctrine is irrelevant as there is no reduction of capital.

While this view of what constitutes capital may be technically correct,[16] a more realistic view of what constitutes 'capital' would recognise the reality that every dollar paid out to shareholders in repurchases is one less dollar available to satisfy the company's debts in the event of a winding-up.[17]

The reality is that the supposed safeguards can never be 100% effective. Take, for example, the Solvency Declaration, which forms the centre-piece of the Australian buy-back provisions. Section 206 BB[18] states that a declaration by the directors as to the solvency of the company must be in force when a buy-back commences. Directors can be held personally liable to the company for the payout to the shareholders in the event that the company is brought under official management or if winding-up is commenced within 12 months after the purchase.[19]

Notwithstanding the significance accorded to them in the Australian legislation, Solvency Declarations are of questionable worth. To begin with, what does 'solvency' mean? Section 206 BH applies the 'equity' or 'Liquidity' definition: the company must be able to pay its debts as they fall due. It is possible to envisage circumstances where a declaration as to solvency could technically be made notwithstanding the fact that on an alternative definition of insolvency, the Bankruptcy test (liabilities exceeding assets), the company is actually hopelessly insolvent.[20]

This definitional difficulty is compounded by the fact that any assessment of solvency must be based on information provided by the management. Shoddy and manipulative accounting practices can effectively render the declaration worthless, if not altogether misleading.[21]

Even where a solvency declaration is made in good faith, however, it can never adequately assess the long-term effects of a repurchase on a company. The ill effects of a repurchase may not be felt for several years, by which time the selling shareholders are long gone.[22] Creditors, in contrast, don't

14 *The Corporations Law.*

15 Ford H A J *'Principles of Company Law'* (5th ed) Sydney 1990.

16 The usual meaning of the term 'capital' is the equity contributed by its members usually through paid-up share capital Section 117 *The Corporations Law.*

17 Kessler R A 'Share Repurchases under Modern Company Laws' (1959-60) 28 Fordham L Rev 637 at 652-3.

18 *The Corporations Law* above.

19 Ford above at 195.

20 Magner above at 100.

21 Harding D 'The ICAC Proposals Regarding Purchase of a Company's Shares' (1978) 10 Comm L A Bull 53 at 53-4 (herein after cited as 'Harding: ICAC Proposals').

always have the luxury of looking to the short-term: they may be locked into the company on a long-term basis.[23]

It may be that the views expressed in this paper as to the efficacy of the safeguards incorporated into the legislation are unduly pessimistic. It might even be conceded that the risks associated with the abuse of the power can be reduced to the absolute minimum. Such concessions, however, do not detract from the central argument - that it is simply not fair that creditors be exposed to any risk associated with the repurchase power in light of the bargain that underlies the whole concept of limited liability.

Without denying the force of this argument, some commentators have nevertheless claimed that the capital maintenance doctrine ought to be jettisoned and a repurchase power recognised because the protection that the doctrine afford to creditors is actually of little value.[24] They point to other supposed shortcomings in our company law, such as the absence of minimum paid-up capital requirements and the failure to require that shares be of a reasonable nominal value, part of which is uncalled.[25] Moreover, they cite the fact that capital can be frittered away in the course of trading as evidence of the futility of a capital maintenance doctrine.[26]

Some of these criticisms of our company law may well be valid, and recommend themselves for reform. In the meantime, however, it is the submission of this paper that the capital maintenance doctrine is still required. This argument is based on an analysis of the apportionment of risk. Simply stated, if a creditor sees fit to extend credit to a shelf company, then it can be fairly assumed that the risks involved were known and accepted when the liability was assumed. In the same way, creditors are taken to assume the risk that the companies with which they deal will lose their capital in the course of their trading activities and may ultimately fail. Assessing and apportioning risk is, after all, the very essence of a voluntary credit transaction.[27]

The risk that a debtor might unilaterally and voluntarily increase the riskiness of a loan after the risk has been assessed and the term of the loan set is qualitatively different. Risks of this nature cannot be assessed when the transaction is entered into; it would be wrong to impose the increased risk on the creditor once that creditor is already locked in.[28]

Even if one were to concede that a creditor might in some cases be taken to have notice that a repurchase might occur, there is still the problem of what Posner calls 'supervision' of the loan. Where a creditor is aware that the

22 Kessler above at 654.

23 Phillips R L 'The Concept of a Corporation's Purchase of its own shares' (1977) 15 Alberta L Rev 324 at 352-3.

24 Magner above at 8.

25 Harding D 'Section 67 of the Companies Act: The Prohibition on Purchase by a Company of its own Shares' (1978) 10 Comm A Bull 31 at 33 (herein after cited as 'harding: Prohibition').

26 SCLRC above at 3.

27 Posner R A 'The Rights of Creditors of Affiliated Corporations' (1976) 43 U Chi L Rev

28 499 at 507-8.

'riskiness' of its loan might be suddenly and dramatically increased, it will have to monitor the debtor much more closely. This monitoring or supervision can be expensive, and the costs get passed on in the form of higher interest rates for all.[29]

Posner is critical of devices such as repurchase powers for the effect that they have on the complex process of allocating risk. He suggests that there is an optimal apportionment of risk between creditors and debtors which ensures that creditors make available to a large enough number of businesses an adequate supply of money at reasonable interest rates so as to ensure a comfortable level of prosperity. To force creditors to accept a greater risk by abandoning the protection offered by the capital maintenance doctrine will upset the equilibrium and may have implications for the economy as a whole. In contrast, reintroduction of the prohibition against repurchases will lessen the risk borne by creditors without materially adding to the risk of shareholders - the result being lower costing credit for all.[30]

It is, of course, entirely possible that one remains unconvinced that the doctrine of capital maintenance provides adequate protection for creditors, thereby justifying continued application of the prohibition against repurchase. Harding makes the point, however, that even an inadequate protection is better than nothing.[31] The limited liability bargain, referred to earlier, requires us to at least attempt to do whatever can be done to protect the security of creditors, regardless of whether those attempts will often be futile. The importance of at least attempting to protect creditors is particularly clear when one is considering the position of involuntary creditors, like those with tort actions against the company.[32]

Choses in action

The Lords hinted at a further conceptual difficulty with share repurchases in *Trevor v Whitworth*. Lord Watson stated that:

> It is inconsistent with the essential nature of a company that it should become a member of itself.[33]

The Lords' observations on this point are rooted in the fact that a share is a chose in action: a bundle of rights.[34] Where a company buys its own shares, one of those rights will be a right of action against itself. Obviously, the company cannot be the owner of a claim against itself.[35] In *Re Dronfield Silkstone Coal Company*,[36] Jessel M R noted that when one considered the

29 Above.

30 Above at 508.

31 Harding: Prohibition above at 34.

32 Clark R C 'The Duties of the Corporate Debtor to its Creditors' (1977) 90 Harv L Rev 505 at 557.

33 at 424.

34 Ffrench H L *'Guide to Company Law'* (3rd ed) Sydney 1990 at 71 See also *Colonial Bank v Whinney* (1986) 11 App Cas 426; and *Archibald Howie Pty Ltd v Commissioner of Stamp Duties* (NSW) (1948) 77 CLR 143 at 156-7 per Williams J.

35 Ford above at 157.

36 (1881) 17 ChD 76 at 83 per Jessel M R at first instance.

provisions of the Act[37] as a whole, but particularly the sections relating to winding-up, the mode of winding-up and the mode of enforcing contributions, it became clear that a company cannot become registered as a member of itself.

Where the company is entitled to retain the shares, as in the United States, difficult questions have to be faced. For example, is the company entitled to receive dividend from itself? Is it liable for calls?[38] In Australia, these questions are partly avoided by the effects of Section 206 PC which provides that bought-back shares must be cancelled and all rights thereto extinguished.

Nontheless, the conceptual difficulty remains. How can one even acquire a right against one's self? To state the proposition is to demonstrate its absurdity. One possibility is that the acquisition of the share operates like the assignment of a debt to a debtor - it acts as a release of those rights.[39] Another possibility which Gower has suggested is that shares are not simply choses in action but are also actual objects of property. The argument seeks to accord to shares special property rights that are capable of being acquired and even retained by the company that created them.[40]

The correct answer to its equitable riddle is unclear. At the very least, however, the notion of share repurchases has resulted in an obfuscation of the principles of equity.

Part 2

Part 2 of this paper seeks to examine the question of what motivates calls for a buy-back power. It is the contention of this paper that while many arguments are advanced in support of buy-backs, a number do not stand up to real scrutiny. Moreover, even where the concerns expressed are legitimate ones, they can usually be addressed by other means.

It is the submission of this paper that the chief appeal of the buy-back power is the opportunities it affords to company managers to entrench themselves in their exectuive suites, immune from takeover.

Even if one does not accept the quasi-philosophical objections to repurchase described in Part 1, one must nevertheless be concerned at the potential for abuse of the buy-back power and its implications for corporate control. Management, it is submitted, has no business inter-meddling in the ownership of a corporation:[41] to empower them to do so is merely to invite abuse of those powers.[42]

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37 *Joint Stock Companies Act* 1867.

38 Leon Getz 'Some Aspects of Corporate Share Repurchases' (1974) 9 UBCLR 9 at 28.

39 Everett D 'Security over Bank Deposits' (1988) ABLR 351 at 363.

40 'Current topics' (1986) 60 ALJ 493 at 494.

41 See eg *Vulcanizeo Rubber and Plastics Company v Scheckter* 162 A 2d 400 (1960) at 404 per Cohen J; also *Faraclas v City Vending Co* 194 A 2d 298 (1963) at 301 per Kenderson J.

42 Subject to qualification that management may have a limited role to play where shares are issued or forfeited.

There are a number of arguments advanced in favour of buy-backs. While it would be incorrect to suggest that these arguments serve only as a smokescreen for a more sinister purpose - facilitating management control - nonetheless most of the arguments can be satisfactorily disposed of. Let us consider some of the more common arguments.

Equity Participation

One of the arguments that is most commonly advanced in support of the buy-back power is that it would facilitate equity participation by employees in the enterprise.[43] The proposition that employees are likely to be more productive and cooperative if they have an ownership interest in the business appears wholly unexceptional.[44] To this end, companies ought to be encouraged to set up employee share schemes which involve the issuing of shares.

What happens when an employee leaves the company? Does he or she take the shares with him? Companies are typically reluctant to see this occur as they tend to view the shares as part of an employed benefits' arrangement which ought to cease when employment ceases. Accordingly, they argue that they need the right to repurchase shares from retiring employees.[45]

Is a repurchase power a necessary incident of an employee share scheme? Clearly, it is not. Schemes can be established wherein shares are issued to a trustee which will involve no reduction of capital.[46] Alternatively, shares can be issued to individual employees with a trustee empowered to acquire and hold the shares on the employee's retirement: recent Australian case law suggests that a company can lend money to the trustee for this purpose without offending the prohibition against giving financial assistance.[47] Moreover, the trustee can be made independent so as to minimise the consequences for corporate control.[48]

The question of share ownership by employees raises the more general issue of equity participation. Share repurchases usually result - at least in the short-term - in a reduction in the number of members in a company.[49] It is hard to see why any measure that results in a decline in equity participation ought to be contemplated. Particularly in Australia, without limited population and small pool of savings, effort should be made to expand the equity base of business rather than facilitate its contraction and concentration in fewer hands.[50]

Another popular argument in the early 1980s was that a repurchase power would offer certain tax advantages to shareholders. This was based on the premise that repurchases resulted in a realisation of capital, whereas

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43 CSLRC above at 34-5.

44 Kessler above at 647.

45 Lipton P, Herzberg A *'Understanding Company Law'* (3rd ed) Sydney 1988 at 173.

46 Harding: Prohibition above at 31.

47 *Condraulics Pty Ltd v Barry and Roberts Ltd* (1984) 8 ASCLR 915.

48 Ryan R 'Repurchase of own Shares for New Zealand' in J H Farrer (ed) *'Contemporary issues in company law'* Auckland 1987 at 99.

49 Harding: ICAC Proposals above at 60.

50 Magner above at 84-5.

distributions of capital under Section 195 we treated for tax purposes as income.[51] Although the distinction was artificial, based as it was on income tax law, it has some merit in the days when capital gains were generally tax free.[52] That tax advantage, however, has largely disappeared as a result of the enactment of a capital gains tax. The differences in treatment of income and capital have narrowed to the point where the arguments in favour of a repurchase power cannot be sustained. One must also recall that repurchases are, for stamp duty purposes, a conveyance while dividend payments and reductions of capital under Section 195 ordinarily are not.[53] Whatever income tax benefits still accrue might be more than offset by the imposition of stamp duty.[54]

Financial Management

A more compelling argument in support of buy-backs is their utility as a financial management tool. A repurchase power would, it is argued, allow companies to manage their own capital bases more efficiently and allow for smoother movements of the capital in the market place.[55]

This argument has considerable merit. Changing business conditions will often make alterations to the capital base necessary. Typically, in a growing business, new shares will be issued to expand the capital base.[56] These may include shares of a different class.

Conversely, the argument goes, there may be circumstances where a return of capital is appropriate on the basis that the company possesses assets or liquidity that are surplus to its needs.[57] While this may suggest a lack of competence and innovation on the part of management,[58] nonetheless it is not an uncommon situation for a company to find itself in an it was to address this need that Section 195 reductions were originally introduced. The criticism is that Section 195 is cumbersome and expensive. A share repurchase power, on the other hand, would make returning capital easier.[59]

The obvious answer to its argument is to be found in Part 1 of this paper: why should creditors be exposed to the risks associated with buy-backs - no matter how minimal those risks might be in practice - to suit the convenience of companies and their shareholders? In any case, it is unclear just how much less cumbersome a buy-back power will prove to be in practice if all of the various safeguards that have been incorporated into the legislation are to

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51 Chirelstein M A 'Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares' (1969) 78 Yale L 739 at 746.

52 Farrer J H , Furey N E et al 'Farrar's Company Law' (2nd ed) London 1988 at 162.

53 Weinberg M N, Blank M V (eds) *Takeovers and Mergers'* London 1979 at 109.

54 Chirelstein above at 740-1.

55 Pollard 'Financial Engineering Philosophies and Precedents' Sydney 1988 at 23.

56 Magner above at 87.

57 Block D J , Barton N E & Radin S A 'The Business Judgment Rule: Fiduciary Duties of Corporate Directors' (3rd ed) 1989 at 247.

58 Chirelstein M A 'Optional Redemptions and Option al Dividends: Taxing the Repurchase of Common Shares' (1969) 78 Yale LJ 739 at 745.

59 Partlett D F , Burton C 'The Share Repurchase Albatross and Corporation Law Theory' (1988) 62 ALJ 139 at 142-3.

be complied with.[60]

Even if there is a degree of inconvenience associated with its use, it is submitted that Section 195 is still the only appropriate procedure for effecting reductions of capital. The provisions allow for proper scrutiny to be applied to the motives behind the buy-back: even where those motives are not, strictly speaking, improper, they might still be of questionable merit. For example, one of the major justifications put forward for buy-backs is that they allow for equity to be reduced so that debt might be increased - an alteration of the debt: equity ratio.[61] While it may in deed be true that debt is often 'cheaper' than equity to service and may offer tax advantages, there must be some question as to whether as a matter of public policy it is appropriate to encourage greater reliance on debt.[62] The legacy of corporate failures from the debt-driven 1980s would tend to deny the appropriateness of such a strategy. Such issues are more likely to be aired in court under Section 195 than in the General Meeting or the Board Room where the buy-backs are considered.

Another dimension to the financial management argument is that a repurchase power would allow the elimination of 'odd lots' - the removal from the market place of shares in less than a marketable parcel.[63] It is obvious that the costs of servicing small shareholders in particular are disproportionately great[64] - quaere whether it is appropriate to allow for a policy that will effectively discriminate against a small player by putting share ownership beyond his or her reach. Once again, such a policy is at odds with the larger public policy of encouraging equity participation. In any case, it is submitted that the 'problem' could be adequately dealt with by the stock exchange giving directions as to purchasing practices.

Yet another aspect of the financial management argument comes in the shape of claims that a buy-back power would assist companies engaging in mergers and acquisitions activity. The argument is that the shares taken off the market can be re-issued to targets as consideration for a merger, for example. In that way, it is suggested the company can avoid dramatically increasing its equity base and potentially decreasing the value of the existing shares when new shares are issued.[65]

Strictly speaking, this practice is impossible under the Australian buy-back legislation. Here, shares are cancelled as soon as they are acquired[66] and thus cannot be re-issued. Nonetheless, new shares can be issued in their place.

On the face of it, it is hard to quibble with the reasonableness of the view expressed above. Notwithstanding that, it is submitted that Section 195 is still a satisfactory alternative. The fact that the formal reduction of capital machinery may be inconvenient to use does not recommend the introduction

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60 Harding: Prohibition above at 742.
61 Ibid at 36.
62 Chirelstein above at 742.
63 Magner above at 89.
64 CSLRC above at 37.
65 Pollard above at 250 See also Harding: Prohibition above at 36.
66 Section 206 PC *The Corporations Law*.

of a buy-back power. As suggested above, the suspicion with which reductions of capital ought to be viewed militates in favour of the least convenient process of reduction.

It is submitted that the actual inconvenience associated with Section 195 reductions is over-stated. For most purposes, formal reductions under Section 195 and repurchases will be interchangeable alternatives.[67] The only real advantage of Section 195 over repurchases may well be the advantage in control terms that accrues to management, of which more will be said later.

The 'financial managers' make one further interesting point: they cite the existence and acceptance of redeemable preference[68] shares as an apparent exception to the rule against buy-backs, and argue that the exception ought to be extended to allow for buy-backs of ordinary shares.[69]

The reality is that the redemption of preference shares is qualitatively different to buy-back of ordinary shares. To begin with, redeemable preference shares have more in common with debt than equity[70] - and no-one suggests that a company should not pay back its debts. Moreover, redeemable preference shares are issued on the understanding that they will be redeemed at some point in the future; ordinary shares are not.[71]

Financial managers also cite the practice of forfeiture of shares where calls remain unpaid as evidence of exceptions to the prohibition justifying relaxation of its rigours. One again, however, a distinction can be made: there is no consideration flowing from the company in the case of forfeiture.[72]

Smaller Companies

Another of the arguments that is commonly advanced in favour of repurchases has particular application to small companies with fewer investors - particularly family companies. It is argued that a share repurchase power would assist the family in retaining control when one of their number dies or retires from the company. A purchase by the company would relieve the family of the need to make the purchase themselves so as to avoid the possibility of an outsider obtaining that parcel of shares.[73]

Where is the public benefit in having the company funds used to create an exclusive club? As Lord Herschell said in *Trevor v Whitworth*,[74] if the other shareholders value their exclusivity so much, let them fund it out of their own pockets. Alternatively, let shareholders issue against the death of a major shareholder and use the payout on the policy to acquire the shares.[75]

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67 Chirelstein above at 741.
68 Section 192 *The Corporations Law.*
69 Boyle A J , Birds J & Penn G (eds) *'Boyle and Birds' Company Law'* (2nd ed) Bristol 1987 at 262.
70 Kessler above at 645.
71 Phillips above at 352.
72 Ffrench above at 71.
73 CSLRC above at 32.
74 Above at 417.
75 Getz above at 29.

It is also suggested that a repurchase power will facilitate small companies in their endeavours to raise equity. Where shares are not readily transferable, potential investors may need the 'sweetener' of having an assured buyer for their shares. There is force in this submission, given the public interest and expanding equity participation; but surely equity can be obtained through use of redeemable preference shares?[76]

A further argument typically put in relation to smaller companies its that a repurchase power would help stabilise the market for shares, particularly where there is a large shareholder who may decide to sell and swamp the market.[77] Leaving aside the risk of market manipulation - of which more will be said later - it is submitted that it should not be the role of companies to protect their shareholders from the vagaries of the market. Investing in the share market is an inherently risky business, and investors must be taken to have accepted the risk of volatility when they entered the market. Volatility presents them with the opportunity for capital gain, as well as the risk of loss - and shareholders are rarely heard to complain about their gains.

Small businesses are accorded a special place in popular mythology. Arguments put by small businesses seeking to secure special privileges for small companies (such as those cited above) cannot, it is submitted, be justified. Shareholders in small companies enjoy the benefits of limited liability just as much as shareholders in large firms; they should be subject to the same strictures imposed by company law in an effort to protect creditors.[78] The fact that small company shareholders may in practice be denied the benefits of limited liability by reason of creditors' growing insistence on the use of personal guarantees is not to the point: it merely suggests that it may be appropriate to reconsider continued use of the company as a vehicle to carry on family businesses in preference to other legal structures.

Selectivity

It is interesting to note that many of the uses proposed for a repurchase power will require the application of that power on a selective basis. Unfortunately, it is when the power is used selectively that the risk of abuse is greatest.[79] The Australian buy-back legislation has recognised this danger by providing for special voting procedures to authorise use of a selective power.[80] These procedures will presumably make it very difficult to obtain authorisation so that selectivity will be comparably rare. The problem for proponents of the power is that, if the power cannot be used selectively, its utility will be considerably diminished. In those circumstances, one is left wondering whether it is really worth having the power at all, even if one does not share this paper's concern for the interests of creditors and the market for corporate control.[81]

76 Magner above at 89.
77 Ryan above at 98-9.
78 *Trevor v Whitworth* above at 437 per Lord Macnaghten.
79 Harding: ICAC above at 58.
80 Section 206 JA sets out the procedures for public companies; Section 206 JB lays out the procedures for private companies.
81 Magner above at 100-1.

There seems good reason to believe, however, that the shareholder approval procedures will present less of a problem to shrewd managers than one might think. Shareholders are generally passive. Their interest in the company will usually extend no further than the amount of dividends that they receive, and the price of their stock.[82] When called upon to vote on a proposal (and it is management which takes the initiative of putting forward the proposal - an influential power),[83] shareholders will usually accede - if they vote at all - to management's wishes, unless those wishes obviously diverge from their own interests.[84] While the legislation provides for extensive disclosure and reporting requirements,[85] in the final analysis the shareholders' decisions are made on the basis of information originally provided by management.[86]

If the safeguards are not effective in circumscribing the use of a selective buy-back power, then the risk of abuse remains. What are the dangers associated with selective repurchases?

Where a large shareholder is able to exit the company with the proceeds of the sale of its shares, there is always the danger that the creditors and the remaining shareholders will be prejudiced by a diminished security. The particular objection to selectivity, however, is that it is unfair as between shareholders.

By definition, selective repurchases entail offering certain opportunities to some shareholders that are not available to others.[87] Unequal treatment of this nature is fundamentally at odds with the object of equality amongst shareholders of the one class.[88]

This injustice is particularly serious when power is used for an improper purpose. An example can be found in the United States case of *Unocal v Pickens*.[89] In that case, the company had made a buy-back offer to all of the shareholders except one - T Boone Pickens, the corporate raider. The object was to leave Mr Pickens as the only shareholder of a company which has been stripped of its capital to pay for the exit of all the other shareholders. The actions of management in this case won the court's approval.

Thus it can be seen that the proponents of buy-backs are trapped on the issue of selectivity. To allow a selective buy-back power is to condone inequity amongst shareholders, and risk the consequences of abuse; while to circumscribe its use will greatly diminish the utility of repurchases in general. A court-sanctioned reduction, in contrast, is relatively straight-forward.[90]

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82 Ryan above at 116.
83 Magner above at 95.
84 Ryan above at 116.
85 Part 2.4, Div 4B Sub-division K.
86 Harding: ICAC above at 57.
87 Getz above at 10.
88 'Purchase by a Corporation by its own Preferred Shares with Dividends in Arrears' note (1946) Uni Chi L Rev 66 at 71.
89 608 F Supp 1081 (1988).
90 Harding: Prohibition above at 37.

Proponents of buy-backs have a further objection to the formal reduction procedures which they say does not apply to repurchases. They claim that court-ordered reductions are essentially involuntary transactions: the shareholders receive their portion of the capital whether they meant it or not. Repurchases, in contrast, allow shareholders to choose whether they wish to receive a pay-out or stay on as a stockholder with an increased interest in the company.[91]

In reality, buy-backs are also coercive. Shareholders are forced to make a decision as to whether they sell their shares, or stay with an increased exposure to the company. It is always possible that a shareholder may wish to do neither.[92] A section 195 reduction at least gives the shareholder the opportunity to adjust his portfolio in any way that he sees fit - if at all. A repurchase limits his options to staying on terms different to those upon which he first invested in the company, or going at a price nominated by the company.[93]

Purchase at large

Up to this point, most of the arguments in support of buy-backs that have been considered relate to the exercise of that power in particular circumstances - by small companies to perpetuate family control, for example, or for the purpose of reducing capital in a more convenient fashion. There are other arguments, however, which on their face apparently seek to give company managers a far greater ability to interfere in the free market for their companies' own shares. The risk associated with this freedom is correspondingly greater and, it is submitted, even more unacceptable.

To begin with, it is suggested that the company ought to be free to buy its own shares as an investment when it believes them to be under-value by the market. A repurchase in those circumstances would act as a signal to the market that management is confident that the shares will increase in value.[94]

Unfortunately, managers are poorly placed to value their stock - perhaps uniquely so. managers are inherently biased when considering the position of their company, since any valuation will inevitably involve an assessment of their own performance. Their perceptions may be deeply flawed, yet they have resources to impose those perceptions on the market.[95] If one accepts that the market valuation of shares is arrived at as a result of the interaction of rational, value-maximising buyers and sellers, then it is obvious that the presence of an irrational buyer with large resources at his disposal will only serve to distort the market and diminish its effectiveness in allocating resources.[96]

It is interesting to note that the argument in favour of repurchases for

91 Partlett above at 142-3.
92 Ryan above at 361.
93 Phillips above at 361.
94 CSLRC above at 38.
95 Above at 48.
96 Ryan above at 104.

investment purposes appears to assume that the shares can still be traded after the buy-back. As noted above, that it not possible under the Australian legislation where the shares are cancelled as soon as they are repurchased.[97]

Any attempt to recognise a right in management to interfere generally in the market will also increase the opportunities for insider trading.[98] It should be noted that it is unclear whether the practice of insider trading is really quite as evil as some commentators assume;[99] nonetheless it is illegal in this country[100] and in most other western economies.

Managers who are prepared to run the risk of breaking our poorly-enforced laws stand to make large gains from insider trading. Using their inside knowledge, they can trade in the market so as to position themselves to take maximum advantage of a repurchase.[101] Information about buy-backs, it is submitted, provide insiders with ideal opportunities to trade.

On a different level, there is also a vexed question of whether a corporation itself can be an 'insider'. Companies always possess price-sensitive information which is not disclosed for competitive reasons: if the corporation then trades in its own securities, is it guilty of insider trading?[102] Canadian legislation, for example, declares that the company is an insider and can be prosecuted as such.[103] Recent Australian authority[104] suggests that that is not the case under Section 1002 of the *Corporations Law.*

A far more serious consequence of recognising a right in companies to invest in their own shares is the possibility of market manipulation.[105]

Management may wish to force the price of stock down so that they or their friends can acquire it at a discount in a 'going-private' transaction. This can be accomplished by slowly repurchasing stock on the market until trading in the shares becomes so thin that the price falls.[106]

More commonly, though, management will seek to use the repurchase power to keep the stock price high. This can be accomplished by effecting the repurchases at a premium. With fewer stockholders, the dividend return per share goes up. The shareholders become the willing victims of a confidence trick - managers use an essentially artificial device that contributes nothing to the process of wealth creation in order to keep shareholders quiet and happy and pliant.[107]

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97 See n 66.
98 W McNeill Kennedy *'Transactions by a Corporation in its own Shares'* (1964) 19 Bus Law 319 at 324.
99 Partlett above at 148.
100 Section 128 *The Corporations Law.*
101 Harding: ICAC above at 59.
102 Ffrench above at 71.
103 See s 121 *Canadian Business Corporations Act.*
104 *Hooker Investments Pty Ltd v Baring Bros Halkerston and Partners Securities Ltd* (1986) 10 ACLR 524.
105 Magner above at 119.
106 Ryan above at 104.
107 Chirelstein above at 745.

Importantly, shareholders that are happy with the 'performance' of their stock are less likely to sell when presented with a takeover offer by an outsider. It is the effect on takeovers of a repurchase power that should be of most concern to policy makers.

While it is possible to concede that some of the practical objections to a repurchase power may carry less weight given the safeguards that may be incorporated into the legislation, nonetheless it is submitted that repurchases can and should be opposed on the sole grounds that they will adversely effect the market for corporate control by stymying takeovers.[108]

Takeovers

How are buy-backs used as a defence to takeovers? As already suggested above, they can be used to keep share prices up through purchases at a premium and effectively increasing dividends per share. In that way, the transaction costs of any bidder are made prohibitively high. But repurchases are even more versatile, and can be of considerable utility to the shrewd, self-interested manager.[109]

One of the uses - particularly where the power is used selectively - is to 'buy-off' dissident shareholders. In its most extreme form, the power is used in 'Greenmail' transactions: a takeover raider who has appeared on the register is removed by having the company purchase his stock at a premium.[110]

In *Trevor v Whitworth*, Lord Macnaghten[111] expressed considerable alarm about any power that allowed management of a company to effectively suppress criticism of its performance through the simple expedient of 'buying-off' the dissidents.[112] Such a process is obviously destructive of shareholder democracy and subverts the whole notion of accountability of management to members. Proponents of the repurchase power seek to provide management with the capacity to silence criticism by members by purchasing their shares, rather than making the effort to address those criticisms.[113]

Even a non-selective power can be used to weed out the dissatisfied, so that those members who remain are more likely to be those who are pliant and supportive. Where the offer is not made on a selective basis, it seems reasonable to assume that a greater proportion of those who are dissatisfied with the performance of a company and management will elect to accept it. Those who support existing management are more likely to stay.[114] With the dissenters and waverers gone, ownership of the company is left concentrated

108 Jarrell G A 'The Wealth Effects of Litigation by Targets: Do interests Diverge in a Merge?' (1985) 28 Uni of Law and Eco 151 at 171.

109 Partlett above at 1444.

110 Pollard above at 250.

111 Above at 435.

112 It is also possible to do the reverse as in *Unocal v Pickens* above where the dissident was locked into the company while all of the other members exited.

113 Dodd E M 'Purchase and Redemption by a Corporation of its own Shares: The Substantive Law' (1941) 89 U Pa L Rev 697 at 100.

114 Ryan above at 100.

in 'friendly' hands who are less well disposed towards selling to a raider.

It is also possible that company managers might seek to make the company unattractive to raiders through careful use of the repurchase power. They might attempt to dramatically increase the ratio of company debt to equity, or they may simply seek to dispose of any surplus cash that the company has which may be attracting unwanted attention.[115]

Buy-backs are a useful weapon in the fight by management to prevent the takeover of a company by an outsider. That management should seek to resist being replaced by a raider with a new management stategy and team is hardly surprising: the desire for self-preservation and the preservation of one's privileges is nearly universal. The normative question of whether or not such resistance ought to be assisted by providing management with the power to repurchase will depend on one's view on the desirability of takeovers.

It is simply impossible in the course of this paper to comprehensively argue the case for and against takeovers. It will, however, suffice to digress briefly to outline the case in favour of an uninhibited market for corporate control[117] and then leave the reader to draw his or her own conclusions.

Agency costs

i Shareholder passivity:

Shareholders, as suggested earlier, tend to be passive, especially in big companies, where the shareholdings are too small and dispersed for individual shareholders to attempt to control the day-to-day affairs of the company.[118] It is not worth the shareholder's time and effort to become involved in the management process, so they employ professional managers to manage on their behalf. The managers are, in effect, agents.[119]

ii Agency costs:

Every agency relationship gives rise to certain costs.

Residual costs are those costs arising out of the fact that agents are not the owners of the enterprise and therefore do not reap all of the gains that flow from their work. As a result, the agent will usually be less than completely committed to furthering the interests of the stockholders, or may seek to 'shirk' his share of the management team's workload, or might even attempt to appropriate to himself gains that really should go to the principal. Alternatively, the manager may be incompetent.[120]

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115 CSLRC above at 39-40.

116 Jennings R W, Buxbaum R M *'Corporations Cases and Materials'* (5th ed) St Paul Min 1979 at 489.

117 The so-called 'Management Entrenchment' thesis.

118 Berle A A, Means G C *The Modern Corporation and Private Property* NY 1968.

119 Easterbrook F H, Fischel D R 'Takeover Bids Defensive Tactics and Shareholders' Welfare' (1981) 36 Bus Law 1733 at 1735 (herein after) cited as 'Easterbrook and Fischel: Takeover Bids').

120 Easterbrook F H, Fischel D R 'The Proper Role of a Target Company's Management in Responding to a Tender Offer' (1981) 94 Harv L Rev 1161 at 1170 (herein after cited as 'Easterbrook and Fischel: Proper Role').

Monitoring costs are those costs incurred by the principals in trying to supervise the agents so as to ensure that they always act in the principal's interests. A typical example of a monitoring cost is the expense associated with auditors' reports.[121]

Bonding costs are the costs incurred in introducing mechanisms that seek to tie the interests of management and owners together. The most obvious example of such a device is the performance-related stock option plan.[122]

Taken together, residual, monitoring and bonding costs make up agency costs. An efficient management team is one that has minimal agency costs so that returns to shareholders are maximised.

How can agency costs be controlled? There are various mechanisms available which are effective to varying degrees. Competition in the product market[123] and in the market for managerial services[124] as well as management-stockholder contracting[125] contribute towards controlling managerial misbehaviour.

Arguably, though, the most efficient disciplinary device is the market for corporate control - which is, in effect, the incentive for mangers to maximise returns to shareholders and minimise agency costs for fear of being replaced by new management should the company be taken over.[126]

The efficacy of the market for corporate control is based on the presumption that capital markets are at least broadly efficient. The efficient capital markets hypothesis suggests that poor performance by management will be reflected in stock prices. Low stock prices attract takeover offers by those who believe that they can extract higher returns from the company's assets.[127]

Proponents of this line of argument suggest that, in the end, the whole community benefits from a healthy market for corporate control. Shareholders are saved the expense involved in monitoring management - raiders, who continually monitor stock performance, do the job on their behalf. The takeover offerer, of course, has the opportunity to make a premium on his investment if he can squeeze higher returns out of the under-utilized assets. The economy as a whole benefits from the fact that resources are distributed to their most efficient users.[128]

If one accepts that takeovers do perform a useful function, as this paper has

121 Easterbrook ad Fischel: Takeover Bids above at 1735-6.
122 Easterbrook and Fischel: Proper Role above at 1197.
Above at 1196-7.
123 De Angelo M, Rice E M 'Anti-takeover Charter Amendments and Stockholder Wealth' (1983) 11 Jnl of Fin Eco 329 at 332.
124 Easterbrook and Fischel: Proper Role above at 1197.
125 Linn S C, McConnell J J 'An Empirical Investigation of the Impact of Anti-takeover Amendments on Common Stock Prices' (1983) 11 JnL of Fin Eco 361 at 394.
126 GJarrell A, Bradley M 'The Economic Effects of Federal and State Regulation of Cash
127 Tender Offers' (1980) 23 JnL of L and Econ 371 at 380-1.
128 Gordon J N, Kornhauser L A 'Takeover Defence Tactics: A Comment on Two Models' (1986) 96 Yale L J 295 at 295-6.

briefly tried to demonstrate, then it follows that any attempt to impede their operation ought to be discouraged.

Proponents of the 'shareholders interests' hypothesis suggest that repurchases actually contribute in a positive way to the takeover process by effectively forcing takeover offers to be made at a price that mangement believes to be reasonable.[129] The offerer is forced into an auction, with the target as to the other bidder. The result, it is argued, is that shareholders' returns are maximised and the company's assets are not seized too cheaply.[130]

On the face of it, such an argument has considerable appeal. If one leaves aside the question of whether managers are well positioned to judge the value of the stock (as discussed earlier), the potential gains to shareholders would tend to argue in favour of such a power.[131]

Easterbrook and Fischel, however claim that creating auctions actually damages shareholder interests. Broadly stated, their argument is that any increase in the costs of acquisition by takeover will reduce incentive for potential acquirers, meaning that fewer bids will result. As bids grow less frequent, the role of takeover as an instrument of corporate control diminishes and company managers feel less compulsion to pursue efficient management strategies.[132]

Some proponents of buy-backs point to the beneficial effects of greenmail as a justification for the power. As noted earlier,[133] Lord Macnaghten expressed grave doubts about the desirability of managers being allowed to buy out their critics. Proponents of the practice, however, argue that greenmail is in fact another aspect of the market for corporate control. As such, they say that a repurchase power can exist without impairing the proper operation of the market for corporate control.[134]

The argument is based on the premise that greenmailers, like takeover bidders, are continually researching the market place looking for undervalued stocks. When a stock is uncovered, purchases are made - the bidder with a view to getting control of the company, and the greenmailer with a view to extracting from the company a premium on its shares when they are repurchased. The prospect of having to pay out a premium to a greenmailer, it is argued, will provide an adequate incentive to management to perform efficiently.[135]

Even if one accepts the logic of the argument, there must be some doubt as to whether managers really fear the prospect of the payout to greenmailers quite as much as they fear losing control in the takeover.

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129 Jarrell above at 171.

130 Bebchuk L A 'The Case for Facilitation Competing Tender Offers: A reply and Extension' (1982) 35 Stan L Rev 23 at 45.

131 Jarrell above at 171.

132 Easterbrook F H, Fischel D R 'Auctions and Junk Costs in Tender Offers' (1982) 35 *Stan L Rev* 1 at 2

133 See 112.

134 CSLRC above at 57.

135 Above.

More to the point, it is submitted that greenmail does not facilitate the operation of the market for corporate control in the manner suggested. The reality is that sometimes the simple fear of being taken over is not enough: the current management team may be genuinely unable to improve efficiency. In those circumstances, it may be in the company's best interests to effect a change in management through a takeover.[136] Greenmail, it is submitted, is an inadequate substitute for takeovers, as greenmailers are 'all bark and no bite'.

As a last resort, the proponents of repurchases point to safeguards designed to prevent the ill-effects described in these pages. They note that the exercise of a repurchase power will always be subject to the fiduciary duty to act in the best interests of the company as a whole.[137]

The difficulty with these so-called restraints is that they are too difficult to enforce, and they are particularly difficult to enforce in this country.[138] Getting a case into court can be problematical: the rule in *Foss v Harbottle*,[139] the rules against class actions, and the difficulties in bringing derivative suits all serve to frustrate the prosecution of abuses.[140]

Even where a case gets into court, courts are reluctant to interfere in the decisions of management so long as they are satisfied that management genuinely believed those decisions to be in the interests of the company.[141] The 'business judgment' rule gives managers considerable latitude in managing their company's affairs and offers an effective degree of immunity from court intervention to control abuses or misuses of company powers.[142]

The business judgment rule has been recognised in the United States for some time. There, courts have accepted that management's decision to repurchase shares with a view to obstructing a takeover is a decision that ought to be left to management where it genuinely believes that that takeover would not be in the company's best interests.[143] There is also Canadian authority to similar effect.[144]

Australian courts have up until this point refused to accept the proposition that management can interfere on purpose in the takeover process with a view to keeping themselves in power.[145] Nonetheless, it was recognised in *Darvall v North Sydney Brick and Tile Company*[146] that the business

136 Above at 55.

137 'Recent Developments': 'Board of Directors may not ratify Chairman's purchase of corporate shares to prevent assumption of control by another without adequate study of threat to corporation' (1962) 62 Col L Rev 1096.

138 Ffrench above at 71.

139 (1843) 67 ER 189.

140 Phillips above at 368.

141 Block Barton Radin above at 250-1.

142 Garavaglia M A 'Shark Repellants Golden Parachutes Crown Jewels and Imagination: Defending Against Hostile Takeovers in Australia and the United States' (1986) 14 ABLR 348 at 351.

143 See for example *Unocal v Pickens* above; also *Cheff v Mathes* 199 A2d 548 (1964).

144 *Teck Corporation Ltd v Millar* (1973) 33 DLR (3d) 288.

145 *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.

146 (1989) 16 NSWLR 260.

judgment rule does apply in this country. Ominously, that case also contained the suggestion that directors do have a role in intervening in takeover offers so as to secure the best interests of members.[147]

Thus, it is submitted that the potential for abuse inherent in a repurchase power is so great that it should not be countenanced. This paper has sought to examine some of the legitimate objects of a repurchase power, and has concluded that they can be satisfactorily accomplished by alternative means. The paper has also sought to examine some of the more questionable objects of buy-backs and has attempted to demonstrate the dangers that will lie if a repurchase power were to be allowed to give effect to them.

Part 3

Proper Purposes

One of the most important bases of the House of Lords' decision in *Trevor v Whitworth* was the doctrine of ultra vires.[148] The Lords felt very strongly that trafficking in its own shares could never be a legitimate object of a company.

The steady decline in the doctrine of ultra vires has diminished the weight of this line of argument in the debate about buy-backs. It may be, however, that the doctrine is making something of a come-back - at least in a limited form. In the recent case of *ANZ Executors and Trustee Company Ltd v Quintex Ltd and Anor*,[149] Mr Justice Byrne of the Queensland Supreme Court reaffirmed the proposition established in *Hutton v West Cork Railway Company*[150] that corporate funds could only be used, and corporate powers only exercised:

> for the purposes which are reasonably incidental to the carrying on of the business of the company.[151]

It is interesting that many of the arguments in favour of buy-backs do not, on their faces, recommend themselves as being 'reasonably incidental to the carrying on of the business of the company'.[152] Consider the object of maintaining family control of a small business, or the goal of protecting shareholders from volatility in the market: how are these purposes incidental to a company's business? Surely they have more to do with shareholder convenience than they do with legitimate company purposes. One might ask similar questions about the argument proposing buy-backs as a superior alternative to reductions of capital under Section 195. Where does their supposed advantage lie? In the relative convenience of management and shareholders.

Of course, the common law doctrine of ultra vires in so far as it still exists may be over-ridden by legislative enactment of a repurchase power. It is

147 Above at 283 per Kirby P.
148 See eg 419 per Lord Herschell.
149 (1990) 8 ACLC 791.
150 (1883) 23 Ch 654; also *Parke v Daily News Ltd* [1962] Ch 927.
151 At 798 per Byrne J quoting Bowen L J in *Hutton* above at 671
152 Hutton above.

submitted, however, that the Parliament should consider very carefully whether it wishes to hand to company managers a device which has so much potential for mischief (as discussed earlier) and yet arguably has little positive contribution to make to the good of the company.

What are the 'proper purposes' of the company? Indeed, what is 'the company' in this context? Proponents of a buy-back power might suggest that the shareholders are the company: that buy-backs are (often) in the interests of the shareholders; and that, ergo, buy-backs can be justified as being in the company's interests. In support, they might quote the decision of the English Court of Appeal in *Greenhalgh v Arderne Cinemas Ltd*[153] where it was stated that the phrase 'company as a whole' in the context of directors' duties meant 'the corporators (the shareholders) as a general body'.[154] Thus, they might say, the fact of shareholder authorisation of the power ought to be enough.

There is authority, however, that suggests that the interests of shareholders (and management) and the interests of the company are not necessarily identical. In *Gaiman v National Association for Mental Health*,[155] it was suggested that in considering the interests of the association or company, it was necessary to consider the interests of present and future shareholders. *Walker v Wimborne*,[156] a High Court case, also suggested that - at least in some circumstances - it might be appropriate to consider the interests of creditors when considering the interests of the company.

Thus, it is submitted, the mere fact that shareholders favour the enactment of a power that may, in some circumstances, facilitate their exit from the company as a commercial entity, should not conclude the debate.

The essential question must be: even if all of the safeguards are effective in preventing abuse and damage to creditors and shareholders, what benefit actually flows to the company from the power? The reality is that the biggest beneficiaries are shareholders (although as suggested earlier, they also face great risks) and - in particular - management. When one considers this proposition in light of the risk of abuse and the difficulties in regulating use of the power, its enactment becomes much harder to justify.

The arguments discussed above are not intended to deny, of course, that the company owes a duty to its shareholders. In light of that, it is interesting to note that the very concept of self-dealing would appear to be at odds with the duty. In most transactions, one party will fare better at the expense - at least notionally - of the other. Share repurchase transactions are no different. If the company buys shares relatively cheaply, then it has compromised its duty to the shareholder by potentially depriving it of gains on the share. Conversely, if the share is bought at a premium, the company will do relatively worse from the transaction. Self-dealing, it is submitted, presents companies with intolerable conflicts of interest. They should not be placed

153 [1951] Ch 286.
154 Per Evershed M R at 291.
155 [1971] Ch 317 at 330.
156 (1976) 137 CLR 1 at 7 per Mason J.

in that position.[157]

Consideration of questions of proper purpose invites discussion of the larger philosophical questions as to what are the appropriate objects of a company. The vexed question of corporate social responsibility presents itself for debate in this context.

There are those who argue that corporations exist for a multitude of purposes. Corporations are said to have 'responsibilities', just like any other citizen, to work directly for the good of the community.[158] In the course of their business, it is considered appropriate for firms to perform 'good works' and to carry out other functions that are not directly necessary nor even reasonably incidental to the carrying on of their particular trade. Companies have the resources at their disposal to do these 'good works'; moreover, since they owe their existence to the community and use the community's resources in performing their functions, it is only fair that they 'give something back'.[159]

The alternative thesis is that corporations should have only one object: profit maximisation, albeit subject to the law (since law promotes order, and order is conducive to profit).

On the other hand, it is argued that profit maximisation produces greater net benefits to the community than ad hoc, potentially inappropriate 'good works'.[160] Social policy ought to be left to the elected specialists in government,[161] while companies get on with the business of maximising wealth for the total community.

On the other hand, it is argued that corporations are so powerful that it would be imprudent and dangerous to unleash them on the community to perform their 'good works' without restraint.[162]

Corporate history is littered with examples of well-intentioned actions, performed for the community's good, with undesirable consequences: the manufacture of napalm by the Dow Chemical Company during the Vietnam war, despite the fact that it was unprofitable[163] (a patriotic duty to support the war) or the support offered by big business to the Nazi party during the dying days of the Wiemar Republic[164] (Adolf Hitler would restore prosperity for all Germans - and he would make the trains run on time).

Proponents of corporate social responsibility would find nothing exceptional about the enactment of a power that did not directly promote profitability,

157 McNeill, Kennedy above at 325.

158 David K 'Five Propositions for Social Responsibility' in G A and J F Steiner (eds) *'Issues in Business and Society'* (2nd ed) New York NY 1977 at 186.

159 Above at 182.

160 Chamberlain N W *'The limits of Corporate Responsibility'* New York NY 1973 at 7.

161 Ackerman R W, Bauer R A *'Corporate Social Responsiveness - The Modern Dilemma'* Reston Virginia 1976 at 7.

162 Levitt T 'The Dangers of Social Responsibility' (1958) 36 Harv Bus Rev 41 at 43.

163 Chamberlain above at 192.

164 Farmer R N, Dickerson-Hogue W *'Corporate Social Responsibility'* Chicago III 1973 at 11.

but had agreeable side effects for management and (in some circumstances) shareholders.

The proponents of profit maximisation, however, would have great difficulty in accepting buy-backs as a legitimate corporate power. As suggested earlier, advantages of the buy-back for the company's bottom line are far from clear. Even where all of the negative side effects of the power can be controlled, and particular sections of the company are in favour of its adoption, the profit maximisation school suggest that the power is essentially a distraction from the real business of companies - namely wealth creation.[165]

The arguments of the profit maximisers are particularly compelling, it is submitted, in this post-1980's era. It is appropriate that we tolerate legal devices that encourage artificial, paper profits? Is it appropriate that we countenance a process that has - at best - a minimal contribution to make to the process of wealth creation? It is the submission of this paper that it is not appropriate, and that the share buy-back provisions should be excluded from our company law.

Conclusion

It is the submission of this paper that a repurchase power ought not be included in this country's re-vamped *Corporations Legislation*. Having considered the mooted advantages of the power, only to find many of the arguments (it is submitted) wanting, and having considered some of the dangers of abuse, it is the submission of this paper that the benefits do not outweigh the risks.

Moreover, it has been the submission of this paper that, on a proper analysis of the concept of limited liability, a repurchase power ought not be retained.

Further, it has been the submission of this paper that on considering the question of what are the proper purposes of company activities, and who are their appropriate beneficiaries, it is at least arguable that a power to buy-back shares has a limited contribution to make to the greater good of the community.

165 Friedman M 'An Economist's Protest' Glenn Ridge NJ 1972 at 180.