



Classes of Shares and Share Redemption in Italian and UK Company Law: the Peculiar Case of the Redeemable Shares

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I. General Introduction

This work consists of a description and comparison of the UK and Italian approaches to equity finance with particular reference to these nations' respective regimes concerning the issue of classes of shares. In this article, the author aims to (i) verify whether UK rules on classes of shares and share redemption are really as flexible as they appear to be or if there are limits to this flexibility; (ii) determine these limits (if any); and (iii) establish if there are possible convergences between the Italian and UK systems.

This kind of analysis may be of some interest to venture capitalists, who invest in companies. From their perspective, the more flexible the equity structure of a company is, the more attractive the investment. It can be argued that the units of measurement for the flexibility of the rules governing equity financing are classes of shares and exit strategies such as share redemption.

This topic merits further discussion because rules governing equity financing have been the subject of complex reform in Italy¹ and of a great deal of criticism and evaluation in England.² In the UK system, rules governing equity financing have always been considered very flexible. Statutory rules, generally speaking, allow the issue of a variety of shares and share redemption may be seen as a flexible instrument for creative equity finance.³ The Italian context is quite different: historically, the Italian Civil Code – which includes rules governing companies – was seen as a rigid system. It provided companies only with mandatory rules and permitted issue of only a few classes of shares. Consequently, both listed and closed companies were frequently constrained to issue debt instruments – such as bonds or bank loans – to finance their investments. Furthermore, the scarcity of equity instruments was not attractive to new investors.⁴ But the Italian situation has now changed: recent Italian company law reforms (in force from 1 January 2004) now allow companies to choose from a number of options and even build a sophisticated equity structure.⁵

Part II of this article deals with the role of the free bargaining approach to the implementation of statutory rules, because this approach seems to have inspired the reform of company law in some European Countries. In this part the concepts of mandatory and default rules as elaborated by the Law and Economics School⁶ and the need to balance these rules in the equity finance context will be considered. In the author's view, these concepts present a useful (and feasible) way to interpret statutory rules concerning the financial structure of companies. Part III deals with the concept of classes of shares. This part provides: (i) a description of the debate concerning the balance between mandatory and default rules in the UK context with particular reference to pre-emption rights; (ii) an evaluation of the construction of class rights suggested at common law; and (iii) an inquiry into possible limits set at common law concerning the creation of classes of shares. Part IV deals with problems concerning redeemable shares. This part presents: (i) a description of statutory rules governing redemption of shares; (ii) a description and assessment of case law; and (iii) an inquiry into possible limits to the use of this class of shares. Finally, Part V contains an evaluation of the topic, with reference to rules governing the issue of shares in other member states of the European Union (EU).

¹ Legislative Decree 6 of 17 January 2003, published in the *Gazzetta Ufficiale* of 22 January 2003, *m. 17, suppl. ord. Riforma organica della disciplina delle società di capitali e società cooperative, in attuazione della legge 3 ottobre 2001, n. 366*, modified by Legislative Decree 37 of 6 February 2004. A second amendment to Decree 6 was recently enforced by effect of *D. Lgs. 28 dicembre 2004, n. 310 (Integrazioni e correzioni alla disciplina del diritto societario ed al testo unico in materia bancaria e creditizia)* published in the *Gazzetta Ufficiale* of 30 December 2004, *n. 305*.

² See P. DAVIES, *Gower and Davies' Principles of modern company law*, (London 2003), p. 613 ff.; and also S. LAURENT, *Capital structure decision: the use of preference shares and convertible debt in the UK*, working paper, downloadable on www.ssrn.com.

³ See *infra* Part IV, Section B 7.

⁴ As, for example, unlisted companies were not allowed to issue redeemable shares.

⁵ For interesting evaluations of equity financing at a European Level with references to the Italian and UK systems, see, e.g., L. ENRIQUES AND JONATHAN R. MACEY, *Creditors versus Capital Formation: The Case Against the European Legal Capital Rules*, *Cornell Law Review*, Vol. 86, No. 6, September 2001; L. ENRIQUES, *Do Corporate Law Judges Matter? Some Evidence from Milan*, *European Business Organization Law Review* 3, p. 765-821; P. FERNÁNDEZ, *Convertibles in Spain: An Example of 'Back Door' Equity Financing*, (November 2001). <http://ssrn.com/abstract=290721>.

⁶ See *infra* Part II.

II. Overview of Contractual Freedom (Free Bargaining) and Equity Financing: the Balance between Mandatory and Default Rules

A. A Definition

The free bargaining (or contractual freedom) approach⁷ is a “key idea”⁸ moulded by the Law and Economics School.⁹ It is probably possible to adopt a working definition of the free bargaining approach even though it is not within the scope of this work to offer a complete framework of the intense debate from which this approach has flowed or to give a universal definition of this theory.¹⁰ For this article, an adequate notion could be the following: “[...The] hypothetical bargaining model involves thinking about what rational transactors would contract for it if they had perfect information, did not face significant transaction costs, and could be fully confident that the agreements reached would be performed as arranged.”¹¹ This definition displays the core features of the free bargaining approach, namely, (i) the need for complete information; (ii) the lack of transaction costs; and (iii) the confidence in the performance of the agreement.

Section B will describe and discuss how these three elements lead to consider default rules as the best rules for the governance of companies. In Section C the opposite view will be described and discussed. In Section D, the two approaches will be evaluated, and Parts III and IV will be introduced.

B. Relevant Features of the Free Bargaining Approach

According to the contractual freedom approach, company law should involve a contractual network of bargaining between its key participants: shareholders, creditors, employees, directors, and managers.¹² The parties are involved in a voluntary bargaining and negotiation process “on the basis of reciprocal expectation and behaviour.”¹³ This view implies that: (i)

⁷ In this article, the terms contractual freedom and free bargaining approach will be used interchangeably.

⁸ This expression was coined by J. BIRDS, *Corporate Law Reform in the UK*, a paper written for a conference held on June 2004, at the Università L. Bocconi of Milan, Italy, on *Corporate Law Reforms in Europe and Law & Economics Methodology*.

⁹ Economic theories of contractual freedom approach were formulated by the School of Chicago as the topic of a symposium held at the Columbia Law School Centre for Law and Economic Studies. These works have been published in a special issue of the Columbia Law Review, (1989), p. 1395 ff.

¹⁰ See F. H. EASTERBROOK – D. FISCHEL, *The economic structure of Corporate Law*, (Harvard, 1996); R. POSNER, *Economic Analysis of Law*, (Boston, 1992); I. AYRES, *Making difference: the contractual contributions of Easterbrook and Fischel*, 59 Univ. Chic. L. Rev. 1391-1420, (1992) and R. M. DAINES – J. HANSON, *The corporate Law Paradox: the case for restructuring corporate law*, 102, Yale L.J. 577-637, (1992); C. JENSEN and J. MECKLING, *Theory of the Firm: Managerial Behaviour, Agency Costs, and Capital Structure*, 1976, 3, J. Fin. Econ., 305; HENRY N. BUTLER, *The Contractual Theory of the Corporation*, 1989, 11, Geo. Mason U. L. Rev., 99. See also RONALD H. COASE, *The nature of the firm*, 1937, now published in Oliver, Williamson, Sidney, *The nature of the firm: origins, evolution and development*, (New York, 1991). See C. JENSEN AND J. MECKLING *Theory of the Firm: Managerial Behaviour, Agency Costs, and Capital Structure, cit.*, whose view offers a more company focused economic analysis.

¹¹ See B. CHEFFINS, *Company Law. Theory, Structure and Operation*, (Oxford, 1997), p. 47, which refers to two versions of the bargaining approach (individualised and generalised). See also I. AYRES and R. GERTNER, *Filling gaps in incomplete contracts: an economic theory of default rules*, (1989), 99, Yale L.J., 87.

¹² For one of the most important contributions to the application of the economic analysis in England, see B. CHEFFINS, *Company Law, loc. cit.*

¹³ See B. CHEFFINS, *Company Law, loc. cit.*

parties should have complete information in concluding and performing their contracts;¹⁴ (ii) the parties are able to bargain by themselves, so there is no need for mandatory rules; and (iii), as a consequence, company law should occupy a residual position. This is important because it introduces the division of company law rules into three classes.¹⁵ The first is represented by mandatory rules, which automatically apply; the second class is comprised of enabling or permissive rules,¹⁶ which only apply if those who may be affected choose to opt in; and the last class is constituted by presumptive or default rules, which apply when shareholders do not opt out of any other rules.¹⁷ According to the free bargaining approach, the conclusion of this liberal view is that lawmakers should be led mainly to consider only permissive and default rules, rather than mandatory rules. In fact, this view considers that permissive and default rules should facilitate the achievement of important goals in economic efficiency. By means of these statutory rules companies should: (i) face lower transaction costs, it being unnecessary to choose a specific rule and to negotiate it; and (ii) customise or vary particular terms as they fit.¹⁸

C. Relevant Criticism

The contractual view has been criticised by many traditionally minded scholars. Firstly, they maintain that “to treat the company as a nexus of contracts is reductionist.”¹⁹ According to Professor Eisenberg, the contract here seems to be a “modified and specialist conception of implicit contract” taken from labour economics where it means neither contract nor – even – bargain.²⁰ A second reason for criticism is the lack of definition of full information as a requirement of the parties’ reaching agreement.²¹ It is also criticised for the need for default and presumptive rules. From this perspective, some problems may arise with default rules, when third party rights are affected or when *ex post* bargaining is necessary especially.²² The

¹⁴ See F. H. EASTERBROOK and D. R. FISCHER, *The corporate Contract*, in Columbia L. Review, (1989), at p. 1416 ff.

¹⁵ See M. E. EISENBERG, *The Structure of Corporation Law*, (1989), 89, Columbia L. Rev. This view is also considered by an English scholar, see J. H. FARRAR, *Farrar’s Company Law*, (London 1991), at p. 94.

¹⁶ With reference to this approach, two important scholars have noted that “[w]hile there are different theories concerning default rules, one influential approach would set default rules by reference to the perfect hypothetical contract at which the parties would have arrived, through bargaining, in the absence of barriers to contracting...” See S. DEAKIN and A. HUGHES, *Economic efficiency and the proceduralisation of company law*, (1999), Company Financial and Insolvency Law Review, at p.180.

¹⁷ See B. CHEFFINS, *Company Law*, *cit.*, at p. 228-229. The examples set out by the author deal, to some extent, with the financial structure of the company. For example, mandatory rules are well represented by the statutory rules governing financial assistance, while permissive and presumptive rules are highlighted respectively by section 162 CA 1985 (share buy back) and by the nature of the rights attached to shares (judges presume that all shares in a company have equal rights) respectively.

¹⁸ See S. DEAKIN AND A. HUGHES, *Economic efficiency and the proceduralisation of company law*, *loc. cit.*, p. 180.

¹⁹ See J. H. FARRAR, *Farrar’s Company Law*, *loc. cit.*

²⁰ See M. EISENBERG, *The structure of corporation law*, *supra* note 15, p. 1461 and J. COFFEE, *The Mandatory/Enabling Balance in corporate law: an essay on the judicial role*, p. 1618; and also L. A. KORNHAUSER, *The nexus of contracts approach to corporations: a comment on Easterbrook and Fischel*, (1989), Columbia L. Review, p. 1455.

²¹ See LEWIS A. KORNHAUSER, *The nexus of contracts approach to corporations: a comment on Easterbrook and Fischel*, *cit.*, at p. 1449.

²² For examples concerning *ex post facto* bargaining, see S. DEAKIN and A. HUGHES, *Economic efficiency and the proceduralisation of company law*, *loc. cit.*

wider consequence of this less liberal view is that mandatory rules should cover an important role in the regulation of the parties' relations.

D. Evaluation

The two approaches described above show the difficulty of reconciling mandatory and default rules in company law. This has been highlighted by Professor Cheffins, who argues that “[l]awmakers, when they formulate legal rules, have an important choice to make in carrying out this task. This is determining the extent to which those subject to the law will have discretion to adopt or displace as they see fit the measures in question.”²³ This seems increasingly to be the task for lawmakers in reforming company law throughout the EU. The exercise undertaken by lawmakers is not easy. On the one hand, they aim to provide new flexible rules and to leave the parties free to choose the rules they prefer.²⁴ In this part of the exercise, the UK system represents an important model that lawmakers seek to imitate. On the other hand, they face the need for mandatory rules and have to take into account the protection of stakeholders such as creditors. In this part of the exercise, imitation of the UK [or UK/British?] model becomes more difficult because Italian courts are not accustomed to balancing mandatory and default rules as UK courts usually do. This type of approach is a new feature of the Italian system which does not fit easily within the Italian civil law tradition.

In this article, these problems will be addressed only in relation to the issue of different classes of shares and redeemable shares.²⁵ The article aims to demonstrate: (i) the flexibility of the UK model; (ii) the caution shown at common law when it faces third party interests; and (iii) the convergences and the differences between UK and Italian rules governing equity financing.

III. Class of Shares and Class Rights

A. Introduction

The Law and Economics approach plays an important role in the interpretation of rules concerning equity finance. It may be useful in particular for the analysis of the mandatory/default rules ratio. With this mode of interpretation an attempt will be made to ascertain how wide the definition of the term class of shares is in the UK. To do this, it is

²³ B. CHEFFINS, *Company Law*, *cit.*, at p. 217.

²⁴ This is the case with Italy, where company law reforms have taken effect from 1 January 2004.

²⁵ A link between equity financing and the free bargaining approach is demonstrated by many authors: see, e.g., E. FAMA, *Agency problems and the theory of the firm*, in *J. Pol.*, 88, 1980; E. FAMA and M. C. JENSEN, *Separation of ownership and control*, in *Journal of Law and Economics*, 26, 1983, p. 301; and J. MC. CONVILL, *The separation of ownership and control under a happiness-based theory of the corporation*, 2005, 26 (2), *Company Lawyer*, p. 35 ff.; FRANK H. EASTERBROOK AND DANIEL R. FISCHER, *The corporate contract*, in *Col. Law Review*, 1989, 89, p. 1416. See also M. VENTORUZZO, *Experiments in Comparative Corporate Law*, which will be published in the *Texas Law Review*. The author has kindly granted a preview of the final draft for the purposes of this article. The first draft of this paper was written for the symposium held at the Università L. Bocconi of Milan (*supra* note 8); and M. LAMANDINI, *The financial structure and the governance of the public companies*, (2001), Bologna.

necessary to consider how class rights are built and the position at common law when courts face the problem of the individuation of uncertain situations as class rights.²⁶

B. The UK Framework

1. Economic Theories in the UK Theoretical and Practical Approaches

Although economic theories were not welcomed by all UK scholars,²⁷ the approach that considers the company a network of contracts is widespread in the UK.²⁸ This has two causes. In the first place, the UK system is at present being influenced by the example of the US where financial markets have pressed for legal changes in capital regime and equity financing rules are frequently established by courts.²⁹ In the second place, UK financial markets have experienced intense pressure to shift towards more flexible statutory rules governing equity financing as well as capital maintenance.

The flexible approach suggested by some authors of the Law and Economics³⁰ has not been suddenly transplanted into the UK system. Since the 19th century, the contractual dimension has always featured strongly in UK company law. In *Wood v Odessa Waterworks Co.*³¹ Justice Stirling held that any member has the right to enforce observance of the terms of the article of association by virtue of the contractual effect given to it by section 16 of the

²⁶ This study will consider neither the legal nature of shares nor the statutory framework of English Law on the issue of new shares. On this topic, see P. DAVIES, *Gower and Davies', loc. cit.* See also *Borland's v Steel*, (1901), 1, Ch. 279, in which a share is referred to as "...the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with [s. 14]...A share is not a sum of money...but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount." See also R. PENNINGTON, *Can shares in companies be defined*, *Comp. Law.* 1989, 10(7), 140-144. For this topic, see E. V. FERRAN, "Legal Capital Rules and Modern Securities Markets – the Case for Reform, as Illustrated by the U.K. Equity Markets" in *Capital Markets and Company Law*, edited by KLAUS J. HOPT and E. WYMEERSCH, (Oxford 2003), at p. 122.

²⁷ See D. SUGARMAN, *Is company Law founded on contract or public regulation? The law Commission's Paper on Company Directors*, 1999, 20, *Company Law Review* (special issue), p. 178; J. DINE, *Fiduciary Duties as a default rules, European influences and the need for caution in the use of economic analysis, ibid*, p. 193.; for a different approach to the economic approach, see J. E. PARKINSON, *Corporate Power and Responsibility, Issue in the Theory of Company Law*, Oxford, 1994. Also, I. O. BOLODEOKU, *Economic theories of the corporation and corporate governance: a critique*, in *Journal of Business Law*, 2002, Jul., 411-438.

²⁸ See B. CHEFFINS, footnote 6 above, at p. 264-360. Given the limits of this article, it is not possible to analyse this theory fully, but it could be useful to report the views of the author in respect of the rules that should govern companies. Some points of criticism were formulated by S. DEAKIN AND A. HUGHES, *supra* note 16, and of the same authors, *Economics and Company Law Reform: A Fruitful Partnership*, in *Company Lawyer*, 1999, 20 (6), p. 212-218. Professors Deakin and Hughes have developed theories which consider the free bargaining approach, arguing that: (i) complete or perfect contracts are not possible through private ordering only; (ii) informational imperfection could limit the capacity of the parties to negotiate contracts in such a way that they can deal with all future contingencies; (iii) the parties are not able to negotiate their contracts freely and without ambiguities. Following this approach, company law should assume a pivotal and not merely a subordinate role because the rules of law can *ex ante* lead the bargaining between parties.

²⁹ See F. KÜBLER, "Rules of capital under pressure of securities markets" in *Capital Markets and Company Law*, edited by K. J. HOPT and E. WYMEERSCH, (Oxford 2003), p. 107-111.

³⁰ See *supra* Part II.

³¹ See *Wood v Odessa Waterworks Co* (1889) Ch D 636 (Chancery Division).

Companies Act (CA) 1862. Other case law was bound by this principle³² which is now embedded in section 14 CA 1985. In recent years, as an effect of gradual evolution, these contractual roots of UK law have led academics and practitioners to adopt the language suggested by Law and Economics. This seems to be true from statements of eminent authors such as Professor Birds, who has emphasised the role of Law and Economics arguing that in the UK the “key idea advanced by this type of economic analysis is to stress the contractual basis of company law” as well as to consider “...shareholders, directors and employees...involved with their company on a voluntary basis.”³³

An example of bargaining between shareholders in the UK context can be found in Table A of the CA 1985, providing default rules for companies in the absence of a choice made by the shareholders.³⁴ Section 2 CA 1985 is also consistent with this approach, since it provides a financial structure

without prejudice to any special rights previously conferred on the holders of any existing shares or class of shares, and allows that any shares in the company may be issued with such preferred, deferred or other special rights or restrictions, whether in regard to dividend, voting, return of capital or otherwise as the company may from time to time by ordinary resolution determine.

As the formula adopted by this rule is very wide, not specifying what the terms preference, deference or special rights really mean, shareholders are substantially free in the creation of equity instruments,³⁵ the only limit being to avoid prejudice to other classes of shares. This elastic approach in the configuration of equity instruments also seems to be reflected at common law. A good example of this is *Cumbrian Newspapers*³⁶ in which Justice Scott held that even the rights conferred on a shareholder in his capacity as such but not attached to any particular shares give rise to a class of shares.

2. Economic Approach and the Reform of English Company Law

The economic approach mentioned above characterises the movement for the reform of English company law.³⁷ It has firstly to be shown that the recommendations issued by the Company Law Review Steering Group, whose final report was published in July 2001, seem to reflect the Law and Economic approach. In the identification of its goal – pursuing “policies to facilitate productive and creative activity in the economy in the most competitive and efficient way possible for the benefit of everyone” – the document seems to consider the economic as well as the free bargaining approach.³⁸ This statement seems to be strengthened by Chapter 1 of the Final Report which concerns the principles, methods and output of the

³² See *Eley v Positive Government Security Life Assurance Co Ltd* (1876) 1 Ex D 88 (Court of Appeal); *Hickman v Kent or Romney Marsh Sheep-Breeders' Association* [1915] 1 Ch 881 (Chancery Division).

³³ See *supra* note 8.

³⁴ See the very recent study of R. HOLLINGTON (Q.C.), *Shareholder's rights*, (London 2004), at p. 14 ff.

³⁵ See E. V. FERRAN, *Company Law and Corporate, cit.*, at p. 44.

³⁶ See *Cumbrian Newspapers Group Ltd v Cumberland Newspaper & Westmorland Herald Newspaper & Printing Co Ltd* [1987] Ch. 1, [1986] 3 W.L.R. 26, [1986] 2 All E.R. 816.

³⁷ It has been argued that the economic theories should have been applied to the reform of company law rather than to an understanding of company law. This topic is developed by B. PETTET, *Company Law*, (Harlow), 2003, at p. 78-81.

document and seems to be inspired by an economic analysis.³⁹ These principles can be summarised as follows: (i) company law should primarily enable or facilitate companies to arrange their own business and transactions in the most efficient way and using the rules judged best suited to their exigencies;⁴⁰ (ii) the competitiveness of a business, even in the international framework, has to be considered in reforming company law. It is necessary to build rules, regarding both management and financial structure, which could attract companies located elsewhere; (iii) information and transparency should be considered the best fellow traveller of the other rules;⁴¹ (iv) as argued by a scholar, among the presumptions that should govern company reform, the approach against interventionist legislation stands out. It considers the important role played by contractual principles and market forces and emphasises partial deregulation because there is always the need for some rules permitting the market to work in the most efficient way;⁴² (v) an important clue is that rules concerning companies should be drawn up with small companies in mind as the basic model to which more complex rules should be added; and (vi) finally, it has been explained that UK law, and English law in particular, should give the greatest flexibility to the founders and controllers of companies to design and structure their business to suit their needs and to choose the rules that permit them to be most efficient.

3. Deregulation versus Mandatory Rules: the Case of Pre-emption Rights

Another good example, concerning equity investments and dealing with economic theories and the balance between mandatory and more flexible rules, is that of pre-emption rights. Article 29 of the Second Company Law Directive provides for rules concerning pre-emption rights. UK law implements the European provision in sections 89-96 CA 1985. The basic principle here advanced is that whenever a company wants to raise new capital and offers new shares for cash, existing shareholders must be given the opportunity to buy the shares in proportion to their existing holding before the new shares are allotted to anyone else.⁴³ It may be noted that both article 29 of the Directive and the provision embedded in the CA 1985 are rather inflexible and prescriptive,⁴⁴ because current law does not allow a company to allot any equity instruments unless it has made an offer to the holder. It is evident that this set of rules could hinder the raising of new capital, the entry of new investors in the companies and even competition with other countries.⁴⁵

³⁹ The principles consist in three core policies: 1. Think small first; 2. an inclusive open and flexible regime for corporate governance; 3. a flexible and responsive institutional structure for rule-making and enforcement, with an emphasis on transparency and market enforcement.

⁴⁰ In any case, it is underlined that this approach does not eliminate the need for legal and other regulatory intervention. THE COMPANY LAW REVIEW STEERING COMMITTEE, *Modern Company Law for a Competitive Economy* (Final Report), *infra* note 48, p. 5.

⁴¹ "...The basic framework of our law should provide the maximum possible freedom to the participants, but combined with the necessary supporting transparency to empower the effective exercise of that freedom within an appropriately framed and disciplined decision-making structure." THE COMPANY LAW REVIEW STEERING COMMITTEE, *Modern Company Law for a Competitive Economy* (Final Report), *infra* note 48, p. 7.

⁴² See E. V. FERRAN, *Company Law and Corporate, cit.*, at p. 639.

⁴³ Public companies can waive pre-emption rights by a special resolution of shareholders, requiring a 75% majority. See THE PRE-EMPTION GROUP, *Shareholders' Pre-Emptive Rights* downloadable on http://www.ivis.co.uk/pages/gdsc4_1.html.

⁴⁴ The UK system provides that the offer to the existing shareholders has to be made in writing and must be kept open for at least 21 clear days.

⁴⁵ For the more liberal regime concerning pre-emptive rights in the U.S., see J.L. COX – T. L. HAZEN, *Corporations*, New York, 2003, p. 496-501 ("Originally, the preemptive right was recognized by the

In the UK, concern has been expressed by both governmental bodies and academics. On the one hand, the Department of Trade and Industry (DTI) in November 2004 asked Paul Myner to examine whether the application of pre-emption rights might hinder companies from raising finance flexibly and to recommend possible solutions. The final report, published in February 2005, underlines reasons for a shift towards a more flexible model as well as “that any changes made in the light of this report to increase flexibility should recognise and reiterate the primacy of the shareholder position.”⁴⁶

On the other hand, it has recently been suggested that modern company law needs to remove inefficient formalities and that the regulatory aspects of an equity finance mechanism, such as pre-emption rights, should be left to market forces,⁴⁷ even though the Company Law Review Steering Group did not seem to be of the same opinion.⁴⁸ It has accordingly been suggested that mandatory rules are not indispensable in avoiding erosion of control and wealth transfer from existing shareholders to new investors – the latter providing the main conventional justification for pre-emption rights.⁴⁹ According to this view, statutory pre-emption rights do not provide complete protection for shareholders. Moreover, the offer made by virtue of pre-emption rights could have coercive effects as held before the ECJ.⁵⁰ Furthermore, it is argued that even the second goal traditionally ascribed to pre-emption rights, the prevention of value transfer to the shareholders, could not be reached with statutory rules rather than by means of market practice as well as the flexible regulation offered by the listing rules.⁵¹

At the European level, there is room for some criticism of the actual legal regime of pre-emption rights as well. Firstly, the High Level Group of Company Law Experts included some suggestions of the SLIM Working Group⁵² in the Final Report (2002), concluding that for listed companies it would be appropriate to allow the general meeting to empower the board to restrict or withdraw pre-emption rights without complying with any formalities.⁵³ Secondly, the formal proposal to simplify the Second Directive on Company Law is directed at simplifying the actual regime, and removing some formalities with which directors are required to comply.

courts as mandatory but now every state by statute allows the corporate charter to limit or deny common law preemptive right or eliminates the preemptive right unless it is affirmatively granted by corporate charter. By express statutory provision in many states a corporation’s article of incorporation may contain provisions limiting or denying preemptive rights.”)

⁴⁶ See DTI, *Pre-emption rights: Final Report*, (2005) at p. 9.

⁴⁷ E. V. FERRAN, *Legal Capital Rules and Modern*, *loc. cit.*

⁴⁸ See COMPANY LAW REVIEW STEERING GROUP, *Modern Company Law for a Competitive Economy. Developing the Framework – Consultative Document*, (2000) and also COMPANY LAW REVIEW STEERING GROUP, *Modern Company Law for a Competitive Economy – (Final Report)*, (2001), in which is asked that the statutory pre-emption be retained for both private and public companies and that no change be introduced in its content or status (p. 160). See J FRANK AND C MAYER, *Governance as a Source of Managerial Discipline*, (2000) consultable on www.dti.gov.uk.

⁴⁹ E. V. FERRAN, *Legal Capital and Modern*, *loc. cit.*; ABI/NAPF, *Joint position paper on pre-emption rights, cost of capital and underwriting*, (1996).

⁵⁰ See *Karella v Karellas* [1991] E.C.R. I-2691.

⁵¹ E.V. FERRAN, *Legal Capital and Modern*, *cit.*, at p. 131 (“The listing rules require pre-emptive offers to be made on a renounceable basis so as to allow existing shareholders who don’t want to invest further in the company to safeguard their financial position by trading their rights to acquire the new shares at a discount price.”).

⁵² The acronym stands for *Simpler Legislation for the Internal Market*.

⁵³ But only where the issue price is at the market price of the securities immediately before the issue or where a small discount to the market price is applied.

Finally, from a comparative perspective, pre-emption rights have been the subject of legal reform. Recent Italian company law reform, enforced in January 2004, has partly reformulated article 2441 of the Civil Code, introducing new rules for excluding or limiting pre-emptive rights. This new regime applies only to listed companies whose articles of association can now exclude these rights up to 10% of the existing capital.⁵⁴

Pre-emption rights are a good example of a gradual shift towards a more deregulated approach in equity financing. It can be argued that this example shows a link between default rules and market forces. In the case of pre-emption rights, market forces support default rules because they can provide protection for shareholders, in avoiding erosion of control and wealth transfer to new shareholders.

4. The UK Debate on Class of Shares

In general, academics and legal practitioners have focused their attention on elements capable of weakening flexibility in equity financing rather than on flexibility itself.

Firstly, arguments have been developed against the adoption of an excessively complex financial structure.⁵⁵ This does not mean that the flexible approach to equity financing should be banned in the UK, but the arguments are indicative of the concern expressed about consequences which would rise from an overly flexible approach to equity financing. In other words, it seems that excessive flexibility would change into rigidity. It is clear that the higher the number of classes of shares issued, the more difficulties companies will face in running their business. Section 125 CA 1985 requires that decisions which can affect class rights need to be approved by a special meeting of owners of classes of shares. The reported opinion once again, clearly shows problems occurring in balancing default rules and mandatory rules.

Secondly, the discussion has also considered non-voting shares. The concern expressed here is focused on the problems concerning the vote, because the lack of this right is frequently viewed as a danger to the equality doctrine, namely that shareholders might not be treated in the same way.⁵⁶ The idea expressed here is that even though a system of equity financing aims to focus only on default rules and thus to be flexible, it cannot be unaware of an important principle such as the equality doctrine. The economic analysis offers two justifications for non-voting shares in the framework of the shareholders' control.⁵⁷ The first is that an investor could buy non-voting shares whether or not there is a class of ordinary shares or other full-voting shares in the company, whose holders are thought to be able to control the management and "whose tendencies towards unequal appropriation to themselves of the company's surplus will be kept in check by the minority protection provisions of the company."⁵⁸ The second reason is that this class of shares could be bought by an investor who thinks that the company will need to return to the market periodically looking for fresh capital and, in consequence, will need to grant good treatment to all shareholders, even to those whose shares have no voting rights attached.

At this point, the common law approach to the financial structure of companies with particular reference to classes of shares should be considered.

⁵⁴ On this point, see M. VENTORUZZO, *Experiments*, *loc. cit.*

⁵⁵ See P. DAVIES, *Gower and Davies*, *cit.*, at p. 618.

⁵⁶ See B. CHEFFINS, *Company Law*, *cit.*, p. 472.

⁵⁷ See P. DAVIES, *Introduction to Company Law*, (Oxford 2002), p. 263 ("To say that no rational investor would buy ordinary shares without the power, ultimately, to remove an under-performing management or to exit the company on fair terms may be a slight exaggeration.").

⁵⁸ P. DAVIES, *Introduction*, *cit.*, at p. 222.

5. Building Class Rights: Elements of Flexibility

a. Statutory Rules

The CA 1985 puts more emphasis on the variation of the class rights than on the power to issue shares. This power seems to be inherent in UK law. It appears to be an important aspect of UK flexibility in regard to the creation of equity instruments, particularly if compared with other EU Member States. Thus, Table A of the CA 1985 establishes the ability of the company to issue classes of shares different from the ordinary class as preferred shares, deferred shares or with other special rights or restrictions attached to them, such as modulated on dividend, voting rights, return of capital or otherwise. The only limit expressed is that the new issue should be without prejudice to any special rights previously conferred. Some principles are established at common law.

b. *Andrew v Gasmeter*⁵⁹

This case introduced a relevant element of flexibility in UK company law. For many years, one of the main principles of company law was that in the absence of an express provision in the (original) constitution equality of shares was an essential condition. Furthermore, it was thought that this provision could not be modified by an alteration of the articles of association. Such a principle prevented companies from issuing shares preferential to those already issued.⁶⁰ Moreover, this principle barred companies, whose original articles provided for continued equality of all shares, from structuring the capital by issuing different classes of shares. In *Andrew v Gasmeter*, a company's authorised capital was GBP 60,000, as stated in its memorandum of association, which also provided the power to increase capital without specifying whether an issue of preference shares was allowed. As the company wanted to acquire additional work, a special resolution was passed by the shareholders' meeting for the alteration of the articles of association and, at the same time, the issue of (new) shares bearing a preferential dividend. The Court of Appeal held that even if, according to section 8 of the Companies Act,⁶¹ the memorandum must state the amount of share capital with which the company proposes to be registered and the division of the share capital into shares, it is the articles of association (and not the memorandum) that must explicitly provide the rights held by the shareholders with regard to their shares. The second principle stated in this ruling was that there is no (implied) condition in the memorandum that all the shares are ranked equally.

c. *The Presumptive Principle of Equality between Shares*

The principle embedded in *Gasmeter* was further developed in *Birch v Cropper*.⁶² As argued by a commentator, although the first case established that there was no implied term in the constitution of a company that all shares should rank equally, there was nevertheless a presumption that all shares do enjoy equal rights. This presumption may be defeated when the terms of issue make express provision to the contrary.⁶³ In *Birch*, the House of Lords reversed the judgement previously given by the Court of Appeal and stated that shareholders, even of different issues, are presumed to rank equally and have to be treated in the same way. In this case, the articles of the company, Bridgewater Navigation Co Ltd (Bridgewater), contained a clause that all dividends should be paid in proportion to the amounts paid on shares, but no

⁵⁹ See *Andrew v Gasmeter Co* [1897] 1 Ch 361 (Court of Appeal).

⁶⁰ See P. DAVIES, *Gower and Davies*, *cit.*, p. 622.

⁶¹ Now section 2 [5] [a].

⁶² See *Birch v Cropper*, Re Bridgewater Navigation Co Ltd (1898), 14 App. Cas., 525, HL; and *Oakbank Oil Co. v Crum* (1882) 8 App. Cas. 65 (HL).

⁶³ See L. S. SEALY, *Cases and Materials in Company Law*, (London 2001), p. 446.

provision referred to winding up. Bridgewater had made two issues of both preference and ordinary shares. The holder of the latter issue claimed that the preference shareholders were entitled only to the return of their capital with 5% interest up to the day of the payment and, later, nothing more. Lord Macnaghten held that the preference shareholder could not be treated as a debenture holder and, in consequence, “they must be treated as having all the rights of shareholders, except so far as they renounced those rights on their admission to the company”. The presumption that has sprung from this decision and which at present regulates the issue of classes of shares in the UK is that all shareholders are presumed to rank equally if the issue of shares does not specify which rights are held by particular classes of shareholders and, moreover, if at the time of issue no distinction is made between these rights with regard to dividends, return of capital and voting rights.

The principles established in *Birch* are particularly important. From a corporate finance perspective, it permits the definition of default rules for capital rights, for instance, that, after repayment of a paid-up capital, ordinary shareholders will receive any surplus equally, in proportion of the value of their shares. The ruling has to be read jointly with Table A, in which any provision concerning the right to vary this principle is contained. This means that companies are allowed to shape their articles on some other basis and, as a consequence, this principle gives great flexibility to companies in customising their financial structure.⁶⁴

From an economic perspective, on the other hand, the presumption that all shares *prima facie* rank equally represents a rational way of avoiding or, at least, reducing transaction costs, it being unnecessary for those who run a company to take time to ensure that the company has dealt with this matter.⁶⁵ What can be observed, then, is, on the one hand, the balance between mandatory and default rules and, on the other hand, the need to have a system which leaves companies completely free to run their business and to shape their capital structure.

d. Ordinary Shares: Default Rules and Common Law Principles

It is now necessary to define the characteristics of ordinary shares to assess how class rights could be built. It will then be possible to outline the flexibility that the UK system adopts in building class rights.

As outlined above, ordinary shares are the default class of shares of a company. If the presumption of equality is not followed by companies, they can freely customise the features of their capital rights, while dividend rights are provided by article 104 of Table A of the CA 1985 which provides that dividends have to be determined in the light of the amount paid up on shares.⁶⁶ Other classes of shares can be moulded varying the features of this model.⁶⁷ As neither statutory rules nor common law provide for a precise definition of classes of shares some problems occur.

⁶⁴ For other observations on this issue, see E. FERRAN, *Company Law and Corporate*, at p. 320-322.

⁶⁵ This perspective is outlined by B. CHEFFINS, *Company Law*, *cit.*, at p. 493.

⁶⁶ As noted by E. FERRAN, *Company Law and Corporate*, *cit.*, this rule has displaced the one “established by the case law that the entitlement to dividend distributions is based on the nominal value of these shares held by each shareholder”. Reference has to be made to *Oakebank Oil Co v Crum* (1882) 8 App Cas 65 HL and to section 119 (c) CA 1985.

⁶⁷ The scope of this work is not to describe all classes of shares that a company can issue. For further observations, see G. MORSE, *Palmer’s Company Law*, vol. 1, p. 6, (London 2004); B. HANNIGAN, *Buckley on Companies Act*, (2004).

There may be room for some concern in the definition of class rights. The common law – even it has not defined the concept – has developed a series of canons of interpretation for this purpose. An eminent author has summarised these principles as follows:⁶⁸ (i) if shares are divided into separate classes, it is a question of construction and case-by-case assessment to identify the rights attached to every single class;⁶⁹ (ii) if shares are *prima facie* entitled to participate in surplus capital should a winding-up occur, they participate in all surplus assets;⁷⁰ (iii) if any rights in respect of any of these matters are expressly stated, that statement is presumed to be exhaustive so far as that matter is concerned;⁷¹ (iv) if a preferential dividend is provided, there is a presumption that it is cumulative: it can be paid one year later than it was paid, before any subordinate class receives a dividend;⁷² and finally (v) preferential rights are presumed payable only if declared.⁷³

6. Ascertaining Uncertain Situations: Balancing in Favour of Flexible Equity Financing?

Even in the UK framework, there is some uncertainty with regard to some kinds of shares, in the sense that it is not clear whether they can be treated as classes of shares or not. The concept of classes of shares is inevitably linked with variation of rights. If an issue of shares or an alteration in the capital structure of companies is considered to affect class rights, namely rights of shares already issued, shareholders can invoke section 125 CA 1985. This provision requires the written consent of three quarters in value of the shares of the class concerned, or the sanction of an extraordinary meeting of the holders of such shares, before any variation of the rights of that class can be made. The need for written consent or a resolution should be a hindrance to directors who wish to issue new classes of shares on financial markets rapidly. Below, case law on variation of class rights will be discussed, because it may show if the courts' approach is really flexible or if it introduces elements of rigidity in equity financing. As will be observed, in balancing the interests of class members and of companies' flexibility in equity financing, UK judges "have not shown themselves anything like so solicitous" of the interests⁷⁴ of the former, namely the class members.

The first case which needs to be considered is *Hodge v James Howell & Co Ltd*. It concerned a company whose share capital was divided into two classes of shares, ordinary and preferred.⁷⁵ As the issue of a new class of preferred shares should have ranked below other preferred shares, but above the ordinary shares, the question was whether this issue would be retained as a variation of the rights of the ordinary shareholder. The Court of Appeal may have rejected this view considering company interests to prevail. It held that the company was not precluded by ordinary rights from issuing a new class of shares. A ratio of this case is that the creation of a new class of shares does not create a variation of the rights of the holders of ordinary shares. This seems to deprive the latter class of shareholders of any

⁶⁸ See P. DAVIES, *Gover and Davies, cit.*, at p. 621624; and also R. HOLLINGTON (Q.C.), *Shareholder's rights, loc. cit.*

⁶⁹ See *Scottish Insurance v Wilson & Clyde Coal Co* [1949] A.C. 462 which overruled *Re William Metcalfe Ltd* [1933] CH. 142.

⁷⁰ See *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch. 353.

⁷¹ See *Scottish Insurance, cit.*(87).

⁷² See *Webb v Earle*, [1875] L.R. 20 Eq. 556.

⁷³ See *Godfrey Phillips Ltd Investments Trust Ltd* [1953] 1 W.L.R. 41; but see *Evling v Israel v Oppenheimer* [1918] 1 Ch. 101.

⁷⁴ See L. S. SEALY, *Case and Materials, cit.*, at p. 450.

⁷⁵ [1958] CLY 446 CA.

protection and in this respect could give grounds for concern but, at the same time, gives companies great flexibility in shaping their equity.⁷⁶

The core question in *Greenhalgh v Arderne Cinemas Ltd*,⁷⁷ on the other hand, is whether the passing of an ordinary resolution subdividing the 10s shares into five 2s shares alters the rights attaching to the 2s shares held by the claimant. In this case, the company had issued ordinary shares, some of 10s and some of 2s each. Greenhalgh held a huge quantity of 2s shares and could control approximately 40% of the votes. Although an ordinary resolution subdividing the 10s shares into five 2s share (each ranking 2s shares) was passed by the holders of the 10s, Lord Greene MR rejected the statement of Greenhalgh that the right attaching to his 2s shares was varied by this resolution. The principle is contained in these words:

Looking at the position of the original 2s ordinary shares, one asks oneself: What are the rights in respect of voting attached to that class within the meaning of article 3 of Table A which are to be unalterable save with the necessary consents of the holders? The only right of voting which is attached in terms to the shares of that class is the right to have one vote per share *pari passu* with the other ordinary shares. If the company for the time being issued (...). I am quite unable to hold that, as a result of the transaction the rights are varied, they remain what they always were.

The two principles outlined in this judgement are that (i) shares having different nominal values cannot be incorporated in the definition of classes of share, and (ii) a change in control of the company cannot be considered a variation of rights. This judgement is relevant for at least two reasons: (i) it shows how judges, when they consider what can be called uncertain situations, give preference to companies' interests; and (ii) it confers a wide flexibility on equity financing as far as the judge held that an alteration in capital structure does not amount to a variation of rights nor, in consequence, does it require the written consent of class members.

*Re Saltdean Estate Co Ltd*⁷⁸ is another case in which UK judges take a position in favour of flexibility of equity financing. Each year, the company's preferred shareholders were entitled to participate in the balance of profits after a 10% preferred dividend and an equivalent sum in dividends on ordinary shares had been paid. Nevertheless, preferred shareholders did not have any right to participate in surplus capital in case of a winding up. This case deals with a request, advanced by ordinary shareholders, to confirm a reduction of capital which was to be effected by paying off the preferred shares at 75p per 50p shares. Justice Buckley approved the reduction and held that the proposed cancellation of the preferred shares did not constitute an abrogation of all rights attached to those shares; as a consequence, an extraordinary resolution of a class meeting of preferred shareholders was not necessary. There is evidence of the exercise applied by the judge in balancing company and class members' interests. Justice Buckley seems to consider many of the concepts dealing with the free bargaining approach⁷⁹ as well as with problems concerning the equilibrium between mandatory and default rules. Firstly, it is worth noting that justice Buckley argues that the width of rights attached to preferred shares is a question of the "bargain between the shareholders and forms part of the definition or delimitation of the bundle of rights which

⁷⁶ It is interesting to note that the Italian approach is quite different, because the prevailing opinion among scholars is that even ordinary shares form a distinctive class and Italian courts seem to have accepted this principle See AA.VV., *Diritto delle società – Manuale Breve*, (Milano 2004), at p. 139.

⁷⁷ *Greenhalgh v Arderne Cinemas Ltd* [1946] 1 All ER 512, CA. And see also *White v Bristol Aeroplane Co.* [1953] Ch. 65 and *John Smith's Tadcaster Brewery Co. Ltd., Re* [1953] Ch. 308.

⁷⁸ See *Re Saltdean Estate Co Ltd* [1968] 1 WLR 1844, [1968] 3 All ER 829 (Chancery Division).

⁷⁹ See *supra* Part II.

make up a preferred share.” Secondly, he gives a narrow view of section 72 CA 1948 (now section 127 CA 1985), upon which opponents place some reliance because it relates to the shareholders’ right to object to variation. It can be argued that this attitude of the judge demonstrates his opinion that a narrow interpretation is necessary when mandatory rules are applied. Thirdly, even though the balance is in favour of company’ interests, justice Buckley says that, as a matter of general principle, there is a limit – unfairness – beyond which it is not lawful to go and which should give preferred shareholders entitlement to invoke section 127 CA 1985. He applies the unfairness test, holding that, at least in this case, the reduction of capital is in accordance with the right and liability to prior repayment of capital attached to preferred shareholders’ shares.

Similarly, in *House of Fraser plc v ACGE Investments Ltd*,⁸⁰ the House of Lords upheld the principle enshrined in *Re Saltdean*, arguing that where a right is fulfilled and satisfied, it ceases to exist and, consequently, does not involve any variation of rights. Thus,

[...] the proposed cancellation of the preference shares would involve fulfilment or satisfaction of the contractual rights of the shareholders, and would not involve any variation of their rights. Variation of a right presupposes the existence of the right, the variation of the right and the subsequent continued existence of the rights as varied.

7. **Widening the Concept of Variation of Class Rights: Balancing in Favour of Class Member Interests?**

a. *The Formal Approach*

As has been observed above, classes of shares and class rights involve a balance between interests and between mandatory and default rules. On the one hand, judges emphasise rights attached to shares, as bargained between the members of a company. In the preceding section,⁸¹ the conclusion was that courts tend to be reluctant in relation to uncertain situations in identifying variations of class rights. If this is true, the courts’ approach can be seen as flexible, because it allows a company to structure capital without facing formalities required under section 125 CA 1985.⁸² On the other hand, a relevant impediment to freedom in equity financing may be represented by an extensive interpretation of variation of rights. Companies would increasingly meet hindrances in structuring their capital, if judges gave a broad interpretation of this concept. For every new issue of different classes of shares, it would be necessary to obtain the consent of the other class members. Statutory rules do not help judges in solving this problem, because rules are generally synthetic and do not contain any definitions. Section 125 CA 1985, which concerns the variation of rights regime, does not give a precise definition of classes of shares. It states: “This section is concerned with the variation of the rights attached to any classes of share in a company whose share capital is divided into shares of different classes.” Similarly, section 429 CA 1985, relating to the right of an offeror to buy out minority shareholders if some conditions are satisfied, uses the term class rights without giving a proper definition.

Despite this lack of statutory rules, generally speaking it might be thought that a class of share would only exist when the articles of association divide the shares into various classes. According to the conventional view, class rights are either rights specially conferred

⁸⁰ *House of Fraser plc v ACGE Investments Ltd* [1987] AC 387, [1987] BCKC 478, HL.

⁸¹ See *supra* Part III, Section B 6.

⁸² As argued by E. V. FERRAN, *Company Law and Corporate, loc. cit.*, many cases show the *prima facie* rule that reduction of capital should be effected in a manner which conforms with class rights. See *Bannatyne v Direct Spanish Telegraph Co* [1887] 34 Ch D 287, CA 300; *Re Chatterley-Whitfield Collieries Ltd* [1948] 2 All ER 593m CA, 596. See also G. MORSE, *Palmer’s Company Law, loc. cit.*

on a class or fundamental rights enjoyed by a class even if they are also enjoyed by another class.⁸³ However, an important case seems to have taken a broader view of the term and, consequently, to have balanced the interests of class members and capital structure in favour of the former.

b. The Substantive Approach

In *Cumbrian Newspapers*⁸⁴ the plaintiff and defendant were companies carrying on the same business. As they were afraid of acquisition by a nation-wide competitor, the plaintiff first acquired 10% of the shares of the defendant. The two companies then entered into an agreement which, *inter alia*, provided for the amendment of the defendant's articles. In particular, to the plaintiff were granted both rights of pre-emption over other ordinary shares and unissued shares and the right to appoint a director. A peculiarity of this right was that it could be exercised conditional on the plaintiff's holding not less than the percentage of shares acquired (10%). After some years, the directors of the defendant proposed to convene an extraordinary meeting to cancel the articles which gave the plaintiff its special rights. The plaintiff asked for a declaration that these were class rights and could not be abrogated without its consent, and for an injunction restraining the defendant from convening or holding the extraordinary general meeting. Justice Scott held, first of all, that class rights may be classified into three kinds: (i) rights annexed to particular shares, which commonly constitute a class; (ii) rights conferred on individuals in their capacity other than as shareholders; and (iii) rights conferred on a shareholder in his capacity as such, but not attached to any particular shares. This was the plaintiff's claim, because the right to appoint the director was attached to a member of the company and not to some shares.

Another recent decision which merits consideration is *BML Group v Harman*,⁸⁵ concerning class rights created by a shareholders' agreement. The difference between this case and *Cumbrian Newspapers* is that in the former the right to be present at a meeting of the company in order for it to be quorate was attached to a class of share. Nevertheless, some commentators have argued that the judge should have considered this right a class right, as in *Cumbrian*, even if this right had been tied to the shareholder as an individual.⁸⁶

c. Criticism of the Substantive Approach

The first decision considered has been criticised by some scholars. Firstly, it has been argued that rights attaching to a member of a company instead of a group of shares do not deserve to be protected from variations.⁸⁷ This view seems to be plausible when it is considered that, distinct from a class of shares, these individual rights are, in a manner of speaking, lost when transferred. Secondly, it has been suggested that the principle stated by justice Scott in *Cumbrian* is not effective when applied to a different situation.⁸⁸ The author referred to here considers the case in which a company proposes to alter its articles of association to extend a lien from partly-paid shares to fully-paid shares. In other words, the issue here is whether

⁸³ See J. BIRDS, *An odd construction of class rights*, *Company Lawyer*, 1986, 7(5), p. 202-203.

⁸⁴ *Cumbrian Newspapers Group Ltd. v Cumberland & Westmorland Herald Newspaper & Printing Co. Ltd.*

⁸⁵ [1994] 2 B.C.L.C. 674. But see also *Union Music Ltd v Watson* [2003] 1 B.C.L.C. 53, CA.

⁸⁶ See G MORSE, *Palmer's Company Law*, *loc. cit.*

⁸⁷ See J. BIRDS, *An odd construction*, *loc. cit.* This author argues that with regard to justice Scott's perspective, it also has to be appreciated that "...he overlooked the fact that there would be some protection at common law (the requirement that alterations be bona fide for the benefit of the company as a whole) and protection under statute against unfair prejudice (ss. 459-461)"; K. POLACK, *Company Law Class rights*, 1986, *Company Law Journal*, p. 399.

⁸⁸ E.V. FERRAN, *Corporate finance and company law*, *cit.*, at p. 336 and 339.

partly-paid shares may be treated as a class different from fully-paid shares: can the freedom from the lien originally attached to fully paid shares be legally qualified as a right given to certain shareholders? In the author's view – which the author of this article would share – the answer should be no. A positive answer would go beyond the principle stated by justice Scott which considered rights given to individuals independently from the shares that they held. Moreover, it has been suggested that the dictum of justice Scott, according to which the distinguishing mark of a class right is exclusivity, has the effect of narrowing the scope of the protection of minorities and should not, therefore, be followed.⁸⁹ Thirdly, the principle stated by the Court of Appeal in *Union Music Ltd v Watson*⁹⁰ may be seen as an implied criticism of a broad interpretation of variation of rights as stated in *Cumbrian*. In this case, Union Music Limited owned 51% of the shares in Arias Limited and Mr. Watson 49%. A shareholders' agreement provided that shareholders should exercise their voting rights so that Arias could not hold any meeting or transact any business at a meeting unless all shareholders were present. Union and Watson were also the two only directors of the company. After Union and Watson had broken their relationship, Watson threatened not to attend any meetings. Union appealed against the refusal of its application under section 371 CA 1985 to order a general meeting of Arias. Union also asked the court to order that the meeting should be considered as validly held even if Union was the only shareholder present.⁹¹ The Court of Appeal overturned the decision of the High Court and ordered that a general meeting could be validly held to appoint a new director even in the absence of Watson. The reasoning of the Court of Appeal is based on the analysis of the nature of the clause of the shareholders' agreement in that it was not held to be intended to create any class right. Thus, a shareholders' meeting only held by Union was incapable of causing any variation of rights. This decision is evidence of a return to the formalistic approach.

C. *The Italian Framework*⁹²

Some background is helpful to explain the Italian approach to the Law and Economics approach and bargaining theories as well as to the effects of new company law.

1. **The Economic Situation**

That the Italian situation was initially characterised by a lack of debate on default and mandatory rules is reflected in the Italian economic framework. Before the reformed company law was enforced by Legislative Decree 6 of 17 January 2003, statutory rules of company law were generally described as a set of mandatory provisions. This burdensome situation was particularly evident in the financial structure of companies. Only a few classes of shares were expressly covered by the Italian Civil Code⁹³ and companies were not allowed to issue shares different from those contemplated by the statutory rules: redeemable shares, tracking stocks, or, at least for unlisted companies, non-voting shares. The creation of separate pools of assets

⁸⁹ E.V. FERRAN, *Corporate finance and company law*, at p. 339.

⁹⁰ See *Union Music Ltd v Watson* [2003], *cit.*; see also the following comments on *Union Music: Impracticable shareholder meetings*, P.L.C., 2003, 14(3), p. 57; *Minority retort – the danger of shareholder vetoes*, Corp. Brief., 2004, Feb., 3-6; *Where a shareholders' meeting cannot be held*, Accountancy, 2003, 131 (1318), p. 123.

⁹¹ See the comment *Impracticable shareholder, cit.*

⁹² Legislative Decree 6 of 17 January 2003, published in the *Gazzetta Ufficiale* of 22 January 2003, m. 17, *suppl. ord. Riforma organica della disciplina delle società di capitali e società cooperative, in attuazione della legge 3 ottobre 2001, n. 366*, modified by Legislative Decree 37 of 6 February 2004. A new intervention for a second amendment to Decree 6 is currently being discussed in the Italian Parliament.

⁹³ The Italian Civil Code contains the statutory rules concerning companies. Listed companies, however, are regulated in Decree 58 (1998).

was barred. Hybrids, financial instruments between debt and equity, were not covered by any statutory provision. On the debt side, the situation was not very different. The Italian Civil Code limited the number of bonds that could be issued to prevent a company from adopting an unbalanced financial structure and the shareholders' meeting could not entrust the board of directors with the power to issue convertible bonds. This kind of rules probably reflected the Italian economic environment which was characterised by a small number of big firms in the international markets, while the overwhelming majority of companies was usually family-based and formed by a tiny number of shareholders. The division between property and control was not commonly observed in practice and the shareholders also covered the role of directors, interested in the management of the business. The consequence was that Italian companies were not in need of default rules nor of sophisticated financial instruments. That is why lawmakers thought that only mandatory and rigid statutory rules could satisfy the needs of firms.⁹⁴

2. The New Regime for Listed Companies: a Compromise

The situation changed in 1998, with the passage of Legislative Decree 58 of 18 February 1998 (also known as TUF⁹⁵), which reformed statutory rules concerning listed companies. In this period, the debate on the nature of statutory rules became more dynamic than it had been in previous years. For the first time, the economic theories developed in the United States and later in the United Kingdom were used to explain statutory rules concerning companies.

This approach was completely new because Law 116 of 1974, then repealed by the TUF, provided a rigid system for equity finance, including a series of mandatory rules governing financial rights attaching to non-voting shares. This law granted to non-voting shareholders a minimum privileged dividend and liquidation treatment (companies could raise the preferred claim): dividend should be equal to at least 5% of the par value and, in any case, had to be equal to that distributed to common stock plus 2% of the par value; moreover, in the case of liquidation, saving shares enjoyed seniority rights over other stocks and had equal rights over what was left after redemption of the par value to all shareholders. Consequently, this system was judged incapable of stimulating market competition between companies in equity financing, because all listed companies issued non-voting shares had the same financial privileges.

The new framework can be described as follows. Whereas closed companies require only or mainly default rules, listed companies generally demand mandatory rules. The reason for this is that listed companies are more limited than closed companies are in conducting their business, the justification of these limits being the public interest, such as the protection of financial markets and investors. Consequently, while listed companies cannot be left free to act on the market, closed companies have to observe more flexible rules. In this way, two goals are achieved: financial markets are shielded and small firms are free to shape their articles as they see fit.⁹⁶ The rules concerning price-sensitive information constitute an important example of these limits. Listed companies are not free to withhold information concerning their activities from the market. In fact, article 114 TUF imposes a strict obligation of disclosure.⁹⁷ This statutory rule can only be avoided by means of a supported

⁹⁴ For a comparative analysis of equity financing in Europe, see S.S. COHEN- G. BOYD, *Corporate Governance and Globalization. Long Range Planning Issues*, Edward Elgar, Cheltenham (UK) and Northampton (USA), p. 78.

⁹⁵ This acronym stands for *Testo Unico della Intermediazione Finanziaria*.

⁹⁶ See F. ANNUNZIATA, *The financial market rules*, Turin, 2004, p. 17-18.

⁹⁷ It is not the aim of this article to analyse the intense debate on the regulation of disclosure for listed companies. It has to be noted that financial information is essential to the gearing of supply and

claim to the *Commissione Nazionale per le Società e la Borsa* (Consob), the independent authority which controls the Italian financial market, when disclosure of information could damage a company.⁹⁸

In any case, the spirit of the new rules was twofold and apparently contradictory, because on the one hand there was a campaign for the adoption of mandatory rules for listed companies and of default rules for closed companies; while on the other, even for listed companies, there were rules in force inspired by the freedom of contract approach. In other words, space was found for default rules governing the financial structure of listed companies: in this case the balance in favour of flexible rules was justified by the need to allow listed companies to create diversified financial instruments. Thus, the free bargaining approach is particularly evident in those statutes which concern the financial structure of companies. A good example is article 145 TUF, concerning non-voting shares (so called *azioni di risparmio*).⁹⁹ This rule provides that, given the absence of voting rights, articles of association should describe and regulate the (financial) privileges attached to these shares. Listed companies have to be able to decide freely in this way which kind of right to assign to non-voting shares in order to compete with other companies. This approach was welcomed by practitioners for it was judged capable of producing good effects on the market, but the adoption of freedom of contract for the financial structure is at present controversial among scholars.¹⁰⁰

3. New Italian Company Law: Prevalence of Default Rules for Financial Structure?

Since the passage of the new rules for listed companies in 1998, the intense discussion has continued and has featured the drafts of the company law reform of 2003, enforced in 2004, which refers to unlisted companies. This is clear both in the preparatory work of the reform and in the new articles of the Italian Civil Code. It should be noted that the official explanation accompanying the new company law has underlined that these new statutory rules will be based on the free bargaining approach. In particular, it states that this view shall characterise rules governing the contribution in the company, the issue of shares and of debt instruments, such as bonds, as well as the right of withdrawal. These provisions have consequently been included in the new rules which have definitively shifted the balance

demand and to the determination of the price of financial instruments. It has been debated whether information should be regulated by mandatory rules or whether companies be completely free. According to the overwhelming majority of scholars, mandatory rules are necessary and this approach arises from the nature of the financial information. Modern legislation adopts a mandatory approach, providing for the compulsoriness of the disclosure. This issue has been discussed in economic literature. See M I STEINBERG – L E MICHAELS, *Disclosure in global securities offerings: analysis of jurisdictional approaches, commonality and reciprocity*, in 20, Michigan Journal of International Law, 1999, p. 207; R ROMANO, *Empowering investors: a market approach to securities regulation* in Yale L.J.N., 1998, p. 8; J. SELIGMAN, *The Historical need for a mandatory corporate disclosure system*, in 9, Journal of Corp. L., I, 1983, p. 18. For a proof analysis of the securities' disclosure rules, see E. FERRAN, *Building an EU Securities Market*, Cambridge, 2004, p. 127-130.

⁹⁸ This aspect of the rule seems not to be affected by DIRECTIVE 2003/6/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 28 January 2003 on insider dealing and market manipulation (market abuse). The Directive has not yet been enforced in Italy.

⁹⁹ Until the 2004 reform, the Italian system permitted only listed companies to issue this class of shares. Following the reform, Article 2351 (2) provides for non-voting shares for unlisted companies as well, even if they are not expressly called *azioni di risparmio*. For a complete overview, see M. NOTARI, *Comment to Article 145, La disciplina delle società quotate nel Testo Unico della Finanza*, edited by P. Marchetti and L.A. Bianchi, (Milano), 1999, p. 1531 and AA. VV., *Diritto delle società – Manuale Breve*, (Milano), 2004, p. 143.

¹⁰⁰ See R. COSTI, *Il mercato mobiliare*, (Torino), 2000.

between mandatory and default rules towards the former. Accordingly, shareholders can: (i) negotiate the weight of their investment without considering the principle of proportion between contribution in the company and shares ownership;¹⁰¹ (ii) issue new classes of shares with the limits provided only by other statutory rules;¹⁰² (iii) issue financial instruments, placeable between debt and equity, whose features can be shaped by the articles of association; (iv) issue bonds without the approval of a shareholders' meeting; and (v) provide for circumstances, different from those contemplated by article 2437 of the Italian Civil Code, that will allow shareholders to exit from the company.¹⁰³

D. Summary

The concept of classes of shares in the UK system have been analysed through statutory rules and common law. UK law seems to be inspired by a wish for great(er) flexibility in the creation of equity financial instruments and of classes of shares in particular. However, case law shows, on the one hand, how a balance between mandatory and default rules in equity financing is difficult to achieve, and, on the other hand, that limits to freedom of contract may be found when variation of class rights is involved. Even though the UK system is inspired by flexibility, this limit could present a hindrance to companies. This flexibility may be reduced by the principles contained in *Cumbrian Newspapers*.¹⁰⁴

The Italian system has also been analysed. Italian law seems to move towards the UK system in that the reform (i) has enforced the principle of atypicalness, namely the ability to create classes of shares different from the ordinary shares by means of a specific provision of the articles of association, and (ii) has created specific statute provisions which allow the creation of new classes of share, such as tracking stocks or redeemable shares, whose features must be determined by statutes.

Nevertheless, the two legal approaches seem not to coincide perfectly. Firstly, the Italian approach adopts a different statutory mechanism for the definition of classes of shares. Even after the company law reform has taken effect, article 2348 of the Italian Civil Code does not show much flexibility in providing a mandatory rule by which "all shares have equal nominal value and give to their holders the same rights". Secondly, Italian companies are required to observe the statutory limits contained in the Civil Code.¹⁰⁵ Thirdly, the UK system, as shown above, seems to be flexible but the impression is that it would be more flexible: the case for reform of pre-emption rights clearly points in this direction. The criticism of *Cumbrian Newspaper* is further evidence of the will to be more flexible in equity financing.

¹⁰¹ New Article 2346 of the Civil Code states that the shareholders are free to shape the relationship between the contribution (in cash or in kind) and the number of shares allotted to a single member of the company.

¹⁰² For instance, Article 2351 (4) which does not allow the issue of multiple vote shares, and Article 2265, which stipulates that any agreement is void which is directed at excluding one or more shareholders from all dividend distribution or losses suffered by the company.

¹⁰³ Article 2437 of the Civil Code grants the right of withdrawal, for example, where the transformation of the company or the change of the business or a variation in the voting rights is authorised by the general meeting.

¹⁰⁴ See *supra* Part III, Section B 7 b.

¹⁰⁵ One of these limits is the ban of the *pactum leoninum* set out by Article 2265 which states that any agreement is void which is directed at excluding one or more of the shareholders from all dividend distribution or losses suffered by the company.

This article will now turn to analysing redeemable shares which can be argued to represent a very interesting field of comparison between the two systems. On the basis of this analysis, it will be ascertained whether the freedom of contract approach of the UK could effectively be transplanted to the Italian model or if there are still some gaps between these two legal systems.

IV. The Peculiar Case of the Redeemable Shares

A. Introduction: the Economic Functions of Redeemable Shares

The redemption mechanism in general and redeemable shares in particular may have a number of functions in terms of corporate dynamics. Firstly, redeemable shares provide a major tool in bringing about the personalisation of a limited company. In other words, a share redemption clause in the company's articles may operate as a useful device to regulate specific relations between the company and its individual shareholders, thereby securing corporate stability. For example, (i) a class of shares carrying ancillary duties may be issued subject to the provision that any such share will be redeemed if its holder fails to perform his duties to the company; (ii) shares may be issued to employees subject to the company's right of redemption, perhaps upon termination of the relevant contract of employment; or (iii) any share may become redeemable only if its holder no longer meets certain subjective requirements. Secondly, from the company's standpoint, redeemable shares may provide an effective device for the protection of the controlling group of owners. In the case of a closed company, redeemable shares may be used to support a provider of finance's exit from the company, who had originally become a shareholder upon subscribing to a new issue of equity. Conversely, in a publicly held company, a share redemption mechanism may serve the function of protecting the company against hostile takeovers or any takeover not agreed to by management. In this case, the possibility to redeem shares would allow the company to reduce the amount of shares outstanding in the market, thereby reducing a prospective acquirer's chances to assemble a sufficient shareholding volume to gain control over the target company. Thirdly, from the shareholders' standpoint, redeemable shares may provide an effective short-to-medium-term instrument for investing in a company's equity. As a result, redemption may offer investing shareholders an easy way to exit the company's ownership structure and, at the same time, a ready means of converting their investment into cash.

B. The UK Framework

1. Statutory Framework

Initially, common law was particularly reluctant to allow companies to issue redeemable shares. This position was probably based on the idea that the possibility to redeem shares, as well as to buy them back, might injure third parties and, specifically, creditors.¹⁰⁶ However, UK law now permits redemption as well as share buy back, which are complementary equity finance mechanisms. Only in 1929 were companies allowed to issue preference redeemable

¹⁰⁶ See the principle outlined in *Trevor v Withworth*, [1887], 12 App Cas., 409. Lord Watson held that "...One of the main objects contemplated by the legislature, in restricting the power of limited companies to reduce the amount of their capital as set forth in the memorandum, is to protect the interests of the outside public who may become their creditors (...) When shares are purchased at par, and transferred to the company, the result is very different. The amount paid up on the shares is returned to the shareholder; and in the event of the company continuing to hold the shares (as in the present case) is permanently withdrawn from its trading capital."

shares,¹⁰⁷ while the redemption of ordinary shares was enforced in 1981. A real economic reason for this kind of limitation does not appear to exist and even the main authors consulted for the purposes of this article are quite perplexed by this approach.¹⁰⁸ It was held that creditors should have more protection from this statutory provision. As this approach did not give flexibility to companies in structuring their capital and there was a gap between this and other more liberal countries, section 159 (1) was enacted in 1981 and the power of redemption of every class of redeemable shares finally acknowledged.¹⁰⁹ Nowadays, the UK rules concerning the redemption of shares seem to have incorporated the European model and Article 39 of the Second Directive, and in some cases to have gone even beyond that flexible model. In this section, this flexible approach will be analysed with a method similar to that used in Part III, in relation to classes of shares. An attempt will be made to answer the following questions. Are rules governing share redemption as well as principles embedded in case law completely flexible in the sense that they leave companies free to shape this class of shares? Are there any limits to this flexibility when interests different from those of companies are involved? May the legal framework of redeemable shares be considered similar to the classes of shares analysed above, or do they represent an example of complete freedom of contract? These problems will be addressed in Part IV, where they will be considered from a European perspective.

2. The Power of Redemption

a. General Provisions and Some Problems of Interpretation

Section 159 (1) CA permits companies to issue shares that are to be redeemed or liable to be redeemed at the option of the company or the shareholder. Despite the wide formula adopted by paragraph (1), three limits are provided: (i) the company must be authorised by its articles; (ii) no redeemable shares may be issued at a time when there are no issued shares of the company which are not redeemable; and (iii) redeemable shares may not be redeemed unless they are fully paid. From a law and economics perspective, the limits set by this rule imply a bargain between the shareholders because whether or not and how an issue of redeemable shares is permitted is left to them to decide. Starting from the analysis of the rationale of the first mechanism set out in section 159 (1) CA – the authorisation of articles – it has to be noted that it may be necessary that the shareholders know the effects of such a transaction. When the company exercises the faculty of redemption and when the company is obliged to redeem the shares, the transaction involves the financial resources of the company.¹¹⁰ However, this mechanism was enforced to give effect to the Second Directive and it is frequently present in the statutes of other Member States.¹¹¹ The second limit set by section 159 (1) CA is directed to avoiding the peculiar and extreme situation that the company could

¹⁰⁷ In 1926, the Greene Committee recommended the introduction of provisions for the issue and redemption of redeemable preference shares.

¹⁰⁸ R. BURGESS, *Corporate Finance Law*, (London 1992), p. 323; E. V. FERRAN, *Company Law and Corporate, cit.*, p. 327.

¹⁰⁹ In relation to the situation under the CA 1948, see R. BURGESS, *Corporate, loc. cit.* (“This power [namely the power now provided by sections 159-161 CA 1985] differs from that under the 1948 Act in that the option to redeem may now be granted to the investor rather than being confined to the company. In principle therefore it would seem possible to incorporate additional protection to equity investment by including in the terms of issue covenants by the company corresponding to those inserted in a loan stock trust deed and by stipulating for the right to redeem to become exercisable (in advance of any contractual redemption date on the occurrence of a breach of covenant.)”).

¹¹⁰ These provisions reflect the formula of article 39 of the EU Second Directive.

¹¹¹ See Spain and Portugal, *infra*, Part V, Section 1.

issue only redeemable shares becoming shareholder of itself, in the case the shares would be wholly redeemed.¹¹² This provision needs to be combined with section 162 (3) CA, which states that “a company may not...purchase its shares if as a result of the purchase there would no longer be any member of the company holding shares other than redeemable shares or shares held as treasury shares.”¹¹³ However, the provision seems ineffective as it does not determine thresholds for non-redeemable shares. In consequence, the rule could be avoided, purchasing all non-redeemable shares but one. Finally, the third limit is directed at avoiding the company’s paying for the redemption of shares without having received any prior payments in cash. The first point is that the requirement that shares be fully paid deals with the capital maintenance doctrine and the protection of creditors.¹¹⁴

As mentioned before, in the UK system, the redemption of shares and share buy-back are strictly connected. Even statutory law contributes to widening the power of redemption. Thus, the rules of redemption have to be read in accordance with section 162 CA 1985,¹¹⁵ which requires companies be authorised by their articles of association to purchase their own shares, including the redeemable shares. This feature of the UK approach lends greater flexibility to the financial structure of companies, because in this way they can purchase redeemable shares outside the redemption scheme as well. This can occur in different circumstances. For instance, if there is no market for the company shares, the buy-back of redeemable shares could be helpful in regaining control of the company¹¹⁶ which had been temporarily lost because of the entrance of an occasional investor in the share capital. Also, in an active market where redeemable shares are trading at a discount to their redemption price, the buy-back of shares could offer a way for the company to save money.¹¹⁷

b. Widening the Power of Redemption

In assessing the extension of the power of redemption, it is necessary to explain the term payment on redemption contained in the CA 1985. A broad interpretation of this expression may constitute further evidence of flexibility. Although the expression is apparently clear, there is dispute about its meaning. The prevailing opinion is that payment on redemption means that the payment for the redemption of the shares has to be made in cash,¹¹⁸ but a recent case seems to have overruled this interpretation. In *BDG Roof-Bond Ltd v Douglas*,¹¹⁹ the relation between the two 50% shareholders broke down almost entirely. In order to avoid deadlock, one of the shareholder decided to sell his or her shares to the others. The shares were not redeemable and the transaction was structured as a share buy-back made by BDG. Moreover, the request of the seller implied consideration partly in cash and partly in kind, with the consequence that BDG would have to pay the shares with some of its assets. The

¹¹² This limit is not explicit in Article 2437-*sexies* of the Italian Civil Code. One of the topics of academic debate is whether such a conclusion is lawful.

¹¹³ On the introduction of treasury shares, see *infra* Part V, Section 1.

¹¹⁴ See R. PENNINGTON, *Pennington's Company Law*, (8th edition, 2002), who outlines the reasons for a change of approach towards the capital rules and the protection of the creditors with reference to share redemption.

¹¹⁵ As modified by the Companies (Acquisition of Own shares) (Treasury Shares) Regulation 2003, SI 2003/ 1116, reg. 2(1), (3) as from December 2003.

¹¹⁶ Before the date of redemption.

¹¹⁷ Because the company acquires the share at a price lower than the redemption price. For other examples, see E. FERRAN, *Company Law and Corporate*, *loc. cit.*

¹¹⁸ *Re Westminster Property Group plc* [1985] BCLC 188 at p. 195, CA; *IRC v Littlewoods Mail Order Stores Ltd* [1963] AC 135; *J P Coats Ltd v IRC* [1997] 1 QB 778.

¹¹⁹ *BDG Roof-Bond Ltd v Douglas* [2000] 1 BCLC 401. This case is very complex and deals with many principles, among which it is possible to find, *inter alia*, the contract duty and the duty of care.

seller never received the assets, but only the cash consideration in advance of the purchase. Subsequent to the execution of the contract, the company was liquidated and the liquidator brought an action against the defendant's solicitors on the grounds that they had been negligent in that they had failed to advise that the repurchase of the company's shares was invalid. In particular the liquidator, *inter alia*, alleged that (i) consideration was not wholly in cash, in breach of section 159 (3) CA; and (ii) the cash consideration was paid too soon in contravention of section 159 (3) CA. With regard to the first point, it has to be noted that Justice Park read section 162 (2) CA jointly with section 159 (3) CA.¹²⁰ Accordingly, he stated that – if a company has the authority to do so on the basis of its articles of association – it can repurchase its own shares from an existing shareholder. In addition, the judge mentioned the main concept underpinning the repurchase (and dividend) payment provisions: a company's sufficient distributable reserves. Reasoning by analogy, the judge held that there was no reason why shares could not be repurchased by the company by payment in specie or in kind. This was because the payment of dividends is based on this concept and consent to the payment of dividends in specie or in kind.¹²¹ The second point arises again from the provision in section 159 (3) CA which, when applied to share purchase transactions, states that the agreement must provide for payment on repurchase. On the one hand, the claimant advanced the literal view, stating that payment could only be made after the agreement had been executed. On the other hand, the judge showed a more flexible approach, stating that prior payment would be rendered conditional on the agreement's being concluded and the sale proceeding as planned. Also in this case, the judge held that the conditionals prevailed over the literal interpretation submitted by the claimant. One author has argued that the judge's approach may indicate a more flexible interpretation of the CA regarding payment by companies.¹²²

c. *Pena v Dale*¹²³

Another recent case deals with the problems concerning the extension of the power of redemption. It may be interesting to see how the claimant and the defendant tried to interpret section 159 (3) CA 1985 in different ways. The defendant's lawyer translated that the terms of purchase must provide for payment on purchase. He contended that that means that the whole of the purchase money would have been paid for on completion. It does not permit payment on deferred terms and in particular payment in two instalments, as occurred in the case of Sulakhan Dale, a shareholder of the company. The claimant's lawyer did not accept this construction of section 159 (3) CA 1985. He put the matter thus: (i) section 164 CA 1985 provides that the purchase of a member's shares by a company must be done by way of a contract, approved in advance; and (ii) section 159 (3) CA 1985 provides that the terms of purchase must provide for payment on redemption. In his view, this means that: (i) the agreement must provide that on purchase of the shares the selling member will receive payment; (ii) the payment must not be made in full at the very split second that the purchase is completed; and (iii) there is no reason to require payment at the precise moment of allotment. According to this construction, what section 159 (3) CA 1985 means is that repurchased shares must be paid for as a condition of purchase.

¹²⁰ Sections 159 to 161 apply to the purchase by a company under this section of its own shares as they apply to the redemption of shares.

¹²¹ See the comment of D. CABRELLI, *BDG Roof Bond Ltd V. Douglas: further observations on the application of Re Duomatic Relief*, *Comp. Law.*, 2001, 22(5), 130-133.

¹²² See D. CABRELLI, *BDG Roof*, *loc. cit.*

¹²³ See *Pena v Dale*, [2004], 2 BCLC, p. 508; [2003] EWHC, p. 1065; [2003] WL 1822940.

The judge held that the payment of the purchase price by instalments did not comply with section 159 (3) CA 1985 with the result that the repurchase was illegal and void under section 143 (2) CA 1985. He stated:

As may well have become clear during the course of argument this is unfamiliar territory as far as I am concerned. In those circumstances it seems to me that it would be a very bold decision by me to refuse to follow the guidance given by Park J and the text books. I am certainly not convinced he is wrong. Indeed it seems to me that his construction is in accordance with the natural meaning of the words of the section.

These two cases show difficulties in determining the extension of the power of redemption: they are further evidence of the balance between a liberal and rigid approach to equity financing.

3. Terms and Manner of Redemption

The timing of the allotment of redeemable shares is a strategic matter, even if some countries have not considered it a crucial feature of this class of shares and have not included it in any statutory provision. The decision when (and how) to proceed to redeem shares may influence the capital structure as well as the gains of companies. It is questionable whether the provisions concerning the timing of the redemption should be the concern of decisions of the shareholders' meeting or of management. The former option is based on the fact that shareholders are the company's owners and should be allowed to decide whether and when to redeem; the latter is inspired by a more liberal approach and seems consistent with the kind of strategic resolution that the directors are used to making. Section 160 (3) CA 1985 deals with this concern stating that "(...) redemption of shares may be effected on such terms and in such manner as may be provided by the company's articles." This provision is problematic, because its meaning is uncertain. Two interpretations are possible. According to the first, section 160 (3) CA 1985 allows the company's articles of association to delegate to the directors a measure of discretion to determine, prior to the date of allotment, such matters as the amount payable on redemption as well as the date of redemption. The second, narrower interpretation requires that the articles of association be prescriptive as to these matters.¹²⁴ As argued in the academic doctrine, the former approach – which once again involves the problem of the balance between mandatory and default rules – would be preferred by companies because it allows "the fine tuning of the terms on which shares are issued to reflect the market condition at the time of issue."¹²⁵ The second approach is probably inspired by the model of redemption offered by Article 39 of the Second Directive. Article 39 (c) states that the terms and manner of redemption must be laid down in the company's statutes or instrument of incorporation.¹²⁶ However, it can be argued that the Second Directive offers no solution to the problem, because it does not clarify which kind of provision and grade of accuracy the articles of association should have.¹²⁷ In the UK context, the case for a change was particularly evident at the beginning of the 1990s. In that period, the Department of Trade

¹²⁴ See COMPANY LAW REVIEW, *Terms and Manners of redemption of Redeemable Shares. Section 159 (A) e 169 (3) of the Companies Act 1975* (DTI Consultative Document) (1993).

¹²⁵ E. V. FERRAN, *Company Law and Corporate*, *cit.*, at p. 451. As reported by this scholar, the liberal interpretation is also reflected in the Australian approach. An example could be found in *TNT Australia Pty Ltd v Normandy Resources NL* (1990) ACSR 1, SA SC.

¹²⁶ E.V. FERRAN, *Company Law and Corporate*, *cit.* p. 451.

¹²⁷ If this interpretation is correct, the Italian provision concerning the redemption of shares may be considered in breach of Article 39, whereas it does not state anything about the term of the redemption.

and Industry (DTI) received strong representations about the disadvantages deriving from the narrower interpretation from both the Law Society and major institutional investors. Section 133 CA 1985 had, of course, inserted a new section 159 [A]. As stressed by the DTI Report, this clause had two main purposes. The first was to clarify that the articles of association could give power to the directors to determine the date of redemption, although this date had to be specified before the share issue.¹²⁸ The second purpose was to make clear that the amount payable on redemption must either be specified in the articles or calculated according to a formula specified in the articles. Moreover, section 159 [A] CA provides that the articles should also specify any other circumstances in which the shares were to be redeemed¹²⁹ as well as the amount payable on redemption¹³⁰ and any other terms and condition of redemption.¹³¹ Nevertheless, the new clause did not receive a warm welcome from either investors or companies, and the DTI suggested its repeal at the first opportunity.

There is an explanation for the unfortunate fate this flexible model has suffered. Firstly, at the time of its introduction in the CA, there was no agreement on the balance between freedom in the creation of equity instruments and the need for mandatory rules. Indicative of this is that – even though section 159 [A] CA offered considerable flexibility – there were still advocates asking for a greater degree of freedom in the redemption of shares. In their view, only a really flexible model would have provided directors with the power for the determination of the amount repayable. In their view, this was probably because in this way directors would be in a position to influence the capital structure of the company. Nevertheless, the DTI explained that this tier of discretion had to be rejected for the following reasons: (i) the DTI had received complaints only about the timing, and not the manner of redemption; and (ii) because of the wording of Article 39 (c) of the Second Directive. Secondly, as argued by some authors, section 159 [A] CA appeared flexible only at first glance,¹³² while it created more problems than the former model, section 159, did. The three main points of criticism formulated against the enforcement of section 159 [A] CA may be summarised as follows.¹³³ The new provision would (i) preclude shares from being issued on the condition that they would be redeemable at the option of the company or as a result of specified events; (ii) create a problem for the consistency of the banks' capital level; and (iii) set up further obstacles for unlisted companies, a high degree of discretion being necessary for the evaluation of the shares to be redeemed.

At this point, the conclusion may be that it is doubtful whether the UK model suffered a real loss of flexibility. UK financial practice has played a central role in lending the redemption of shares provision an important degree of flexibility, despite the lack of enforcement of section 159 [A] CA. The UK approach seems to have exploited all the margins of flexibility provided by the Second Directive and the CA.

Even though, at first glance, the adoption of precise provisions on the time and manner of redemption may appear as a shift towards a mandatory system, section 159 CA is a useful provision for the protection of investors. As the UK discussion on this point shows, the balance between mandatory and default rules is really a problem of internal governance. In other words, the problem consists in identifying the proper organ (shareholders' or directors' meeting) which can lawfully establish the terms and manner of redemption. From the investors' point of view, the power of directors to specify the date or period of redemption

¹²⁸ See DEPARTMENT OF TRADE AND INDUSTRY, *infra* note 162.

¹²⁹ Section 159 [A], (3) CA.

¹³⁰ Section 159 [A], (4) CA.

¹³¹ Section 159 [A], (5) CA.

¹³² See P. DAVIES, *Gower and Davies', cit.*, p. 248; R. PENNINGTON, *Pennington's Company, loc. cit.*

¹³³ E. V. FERRAN, *Company Law and Corporate, cit.*, p. 329.

may not be seen as an essential condition. It may very well be more in accordance with the Second Directive to have a system in which shareholders – by means of articles’ provisions - govern the terms and manner of redemption. One author has suggested that companies should be cautious and avoid letting directors determine share prices or share pricing formulas at their discretion. The way in which UK law regulates this aspect of share redemption – i.e. without a default rule – gives the system more flexibility than it might appear to have on the surface. This effect is completely missing in the Italian system, as will be observed in Section C.

4. Failure to Redeem Shares, Financial Assistance and the Capital Maintenance Doctrine

Share redemption involves concerns in respect to performance in redemption of shares and of the doctrine of the maintenance of capital, redemption implying the use of part of the company’s capital.

On the one hand, according to section 178 (2) CA, if a company is still a going concern, the shareholder may exercise any rights relating to which contract except that the company is not liable in damages in respect of any failure on its part to redeem shares.

On the other hand, share redemption may be to the detriment of companies’ creditors.¹³⁴ Following the guidelines set out in Article 39 (d) of the Second Directive, the CA only provides for the use of designated funds. These are designed to avoid erosion of capital: the CA states that redemption can be realised only out of distributable profits of the company as well as any premium payable on redemption.¹³⁵ The CA also contemplates a concession to this general rule, namely if the shares to be redeemed at a premium were originally issued at a premium.¹³⁶

*Barclays Bank plc v British & Commonwealth Holdings plc*¹³⁷ can be seen as an exercise in the balance between creative equity financing and the need for protection of creditors. In this case, Caledonia Investments plc (Caledonia), major shareholder in British and Commonwealth Holding plc (B&C), wanted to liquidate its holding in B&C. The court approved the scheme under section 425 CA which also involved a reduction of capital. In this way, the company avoided putting a large amount of shares on the market. The shares held by Caledonia were converted into redeemable shares to be redeemed in four tranches. Furthermore, the agreement provided a call option, given to Caledonia, through which it would be able to sell the shares to a vehicle, Tindalk Ltd (Tindalk). Tindalk was financed by a pool of banks, should the company fail to redeem the shares. B&C covenanted with the banks that it would maintain certain ratios and that in case of their breach the banks would be entitled to sue B&C for damages.

¹³⁴ See *infra* note 168.

¹³⁵ Section 160 (1) (a) and (b) CA.

¹³⁶ Section 160 (2) CA. In this situation, any premiums payable on the redemption may be paid out of the proceeds of a fresh issue of shares made for the purposes of the redemption. See *Quayle Munro Petitioners*, 1991 G.W.D. 35-2104. As argued by G. MORSE, *Palmer’s Company Law*, the rationale of this rule is to balance capital going out against capital coming in and to affect the share premium account in so far as it reflects the amount credited to it on the original issue unless that amount has been taken out of that account, for instance through an issue of bonus shares. On this point, see also R. BURGESS, *supra* note 108, at para. 7.106-7.107.

¹³⁷ See *Barclays Bank plc v British & Commonwealth Holdings plc* [1996] 1 BCLC 1, [1995] BCC 19. The case is very important because, it also provides a definition of financial assistance. The Court of Appeal held that the assistance needs “... to be financial in nature and that it has to amount to help as opposed to mere-cooperation.” See K. DAWSON, *Option agreement*, *Company Lawyer*, 1997, 18 (5), 152.

The evaluation of the principles stated in this case is two-fold: on the one hand, the Court of Appeal seemed to favour a cautious approach towards freedom in equity financing, because it confirmed the responsibility of the company for breaching the contract involving its duty to redeem shares; on the other, it held that the covenant granted by B&C did not amount to financial assistance.

The Court of Appeal first deals with the interpretation of section 178 (2) CA 1985 which stipulates that “[t]he company is not liable in damages in respect of any failure on its part to redeem or purchase any of the shares.”

B&C submitted that: (i) these words implied “some connection or relation between the two subjects matters to which the words refer”; (ii) the section applied to primary creditor claims with the result that B&C was not liable to pay damages to the banks; and (iii) B&C’s failure to redeem the preference shares and the damages sought was connected with the claim because the failure of the redemption and the breach of a covenant established by the option agreement arose from the same cause.

The plaintiffs alleged that the words “in respect of” referred to the damages for which B&C would be liable to pay for breach of its obligations under the terms of the issue to redeem the shares.

The Court of Appeal, upholding *Harman*, gave a narrow interpretation of the wording encapsulated in section 178 CA, stating that the loose connection or relationship suggested by B&C was not sufficient. Thus, the Court of Appeal decided that the action was not for damages in respect of the company’s failure to redeem its shares but for breach of the covenant to maintain its asset value.¹³⁸ The reasoning of the Court of Appeal is based on the fact that the prohibition encapsulated in section 178 (2) CA relates exclusively to actions for the company’s failure to redeem its shares. The fact that the damages sought would be calculated according to the failure to redeem did not alter that position. The exercise in balancing an interpretation which favours creditors’ or third parties’ interests rather than only the company’s interests, in this case, resulted in the protection of the latter.¹³⁹

Another question considered by the Court of Appeal was whether the covenant granted by the company amounted to financial assistance for the purpose of acquiring shares. The judge held that: (i) to the term financial assistance should be given the ordinary commercial term; (ii) the covenant was not included in the specific categories of guarantees provided by section 152 CA 1985; and thus (iii) section 152 CA 1985 requires “that there should be assistance or help for the purpose of acquiring the shares”. The principle stated on this point was that

assistance should be of financial nature. Section 152 contains reference to a number of legal terms of which indemnity is only one and the fact that there may be contract under which a party recover the same amount by way of damages as he would have recovered under an indemnity is not sufficient to convert that contract into an indemnity.

Furthermore, the Court of Appeal stated that there was no financial assistance under section 152 (1) (a) (iv) CA and that the fact that the breach of covenants might render B&C liable to damages did not mean that B&C gave financial assistance. At first glance, this principle seems to give a narrow interpretation of financial assistance which should in the abstract favour freedom in this kind of transaction. Although, as argued by one scholar,

¹³⁸ G. MORSE, *Palmer’s*, *cit.*, para. 6.027.

¹³⁹ However, it has been observed that the Court of Appeal did not decide whether the prohibition in section 178 (2) only applies to claims by shareholders for damages or will extend to other directly affected by the company’s failure to redeem, e.g., market makers. (G. MORSE, *Palmer’s*, *loc. cit.*).

warranty or covenant may be a vulnerable category of arrangement which could be caught by this section.¹⁴⁰

Finally, the principle of law which affected companies' right to buy their own shares and give away property did not prevent B&C from making the representations relied on by the relevant plaintiffs, nor did they prevent B&C from being liable for the consequences.¹⁴¹

Although the decision in *Barclays* represents an isolated case, the principles stated by the Court of Appeal have to be considered for several reasons. Firstly, they show how judges may be reluctant in allowing such transactions where third parties' interests are involved. Secondly, they clearly display the extent to which sophisticated equity transactions involving redemption of shares can be affected by fundamental principles of company law. Finally, the Court of Appeal clearly shows that freedom in equity financing and in the issue of redeemable shares could be stopped by third parties' interests: an in-depth examination is necessary to ascertain whether an arrangement through which a company tries to guarantee redeemable shareholders that they will obtain capital payment where the shares are due to be redeemed even though the company is insolvent, adheres to the capital maintenance doctrine.

C. *The Italian Framework*

1. Introduction: Article 2437-*sexies* of the Italian Civil Code

Redeemable shares have newly been provided for under Article 2437-*sexies* of the Italian Civil Code, which contains recently revised company law provisions. The applicable provisions have been set out in Section X of Chapter V of the Civil Code. This section is intended to regulate the manners in which amendments may be made to a company's articles of association. The new statutory article requires that certain rules governing the exit (*recesso*) from a company's ownership structure shall also apply to shares or classes of shares in respect of which the articles of association entitle the company as such or any shareholders to exercise share redemption rights. These rules specifically state, *inter alia*, the criteria according to which the value of the shares must be determined (Article 2437-*ter* of the Civil Code) and settlement made (Article 2437-*quater* of the Civil Code). Thus, the lawmaker has not directly provided for redeemable shares as a new class of shares. The inclusion by reference technique has been used instead, although restricted to two specific aspects of retraction, without exhaustively covering redeemable shares. It should be mentioned that mechanisms allowing for share redemption were not entirely foreign to Italian company law even before it was reformed and Article 2437-*sexies* newly introduced. Nor is the Italian Civil Code entirely void of provisions applicable to the redemption of equity instruments.¹⁴²

As already briefly highlighted above, it should be noted that the introduction of redeemable shares somehow reflects the philosophy underlying the recent reform of Italian company law, at least in respect of the financial structure of a company limited by shares (*società per azioni*). Limited companies are now more conspicuous for the more flexible approach to their incorporation than they were in the past, probably as a result of the free bargaining approach under which allowance is made for rules (default rules) somewhat at variance with a company's self-regulatory articles of association, as contrasted with the high

¹⁴⁰ E.V. FERRAN, *Company Law and Corporate*, *cit.*, p. 391.

¹⁴¹ See K. DAWSON, *Option agreements*, *Comp. Law*, 1997, 18(5), p. 152.

¹⁴² Some issues arising in connection with the redemption of company shares have also been dealt with extensively both at case law and in doctrine — most decisions and comments conveying a more open-minded approach to the admissibility of share redemption clauses even though there were no specific provisions of law to rely on. Further discussion of these issues falls outside the scope of this article.

degree of compulsoriness of the so-called mandatory rules. In fact, these principles have now found their way into the second paragraph of Article 2348 of the Civil Code, expressly providing for the atypical nature of certain classes of shares. As far as the redemption of shares is concerned, the Italian system seems to be still less flexible than the UK rules.

Below, some of the problems that have arisen after the introduction of this new class of shares will be discussed.¹⁴³

2. Interpretation Issues

a. Preliminary Doubt

From a systematic standpoint, what cannot be understood in full is why share redemption rights have been provided for within the scope of Section X of the Civil Code, which is intended to govern the ways in which a company's articles of association may be amended. Some assumptions can be made in this respect. First, the lawmaker may have chosen to do so in order to facilitate the co-ordination of the new provisions with the provisions of Articles 2437-*ter* and 2437-*quater*. Secondly, share redemption may have been likened to *recesso*, the right of exit from share ownership, since both appear to be mechanisms permitting a shareholder's exit from the company's shareholding structure, much as redeemable shares can be used by the company as a device to exclude the redeemable shareholder from such a structure. Thirdly, the purpose may have been to emphasise the effects of share redemption once the option has been exercised, since it may result in the company's capital being reduced and the company being required to amend its articles of association accordingly. This is not merely a theoretical assumption, since the systematic framing of Article 2437-*sexies* within Section X may be viewed as a useful way out of some problems the new provisions would hardly resolve by themselves. In this last respect, a telling sign is the brevity of Article 2437-*sexies*, which only regulates two aspects of share redemption by reference to the provisions applicable to retraction, without dictating a definition of redeemable shares, identifying their nature as equity instruments or regulating the manners in which redemption rights should be exercised. Nor does the Memorandum on Legislative Decree 6 of 17 January 2003 allow the reader to solve such issues, since it merely states the philosophy underlying the introduction of redeemable shares in the Italian civil law system, while stressing the reference that is made in Article 2437-*sexies* to Articles 2437-*quater* and 2437-*quinquies* intended to regulate retraction. In fact, the Memorandum stresses the fact that redeemable shares have been found especially useful, for example, "where the shareholder's interest in the company's equity is justified by non-shareholding arrangements, such as contracts for the supply of services or materials." Yet, the rationale behind the reference made to the criteria applicable to the determination of the share value in the event of retraction, along with the requirements to be met when the company's own shares are to be purchased, appears to be the need to maintain the company's capital.

¹⁴³ For this section, the following Italian studies will be considered: L. CALVOSA, *La clausola di riscatto nella società per azioni*, (Milan), 1995; G. CARCANO, *Riscatto di azioni e azioni riscattabili*, 1983 (II) Giur. comm., at p. 397; G. B. PORTALE, *Azioni con prestazioni accessorie e clausole di riscatto*, 1982, Riv. Soc., at p. 703 ff.; M. PERRINO, *Le tecniche di esclusione del socio dalla società*, (Milan), 1997, at p. 26 ff.; D. GALLETTI, *Il recesso nelle società di capitali*, (Milano), 2000, at p. 282 ff.; A. PISANI MASSAMORMILE, *Azioni e strumenti finanziari partecipativi*, 2003, Riv. Soc., at p. 1268 ff.; A. PACIELLO, *Art. 2437-*sexies* – Azioni riscattabili, Società di capitali – Commentario*, edited by G. NICCOLINI e A. STAGNO D'ALCONTRES, (Napoli), 2004, at p. 1146; M. NOTARI, *Azioni e strumenti finanziari*, in *Il nuovo ordinamento delle società – Lezioni sulla riforma e modelli statutari*, edited by S. Rossi, (Milano), 2003, at p. 45 ff.

b. Are Redeemable Shares a Class of Shares?

It may be wondered whether redeemable shares are a separate class of shares within the meaning of Article 2348 of the Civil Code. If the answer is that they are, the main consequence would be that the requirements of law applicable to class meetings under Article 2367 of the Civil Code should equally apply to any company that issues redeemable shares. As a consequence, a further element of rigidity is introduced in the Italian system because, according to Article 2367, a separate resolution of class members would be necessary to approve transactions involving redeemable shares and affecting rights attached to the other classes of shares. Moreover, this may introduce many uncertainties if it is considered that actions under Article 2367 are judged in a different way by the Italian Courts.¹⁴⁴

c. Who is Entitled to the Redemption?

The wording of Article 2437-*sexies* does not make clear who is entitled to the redemption. Even scholarly opinion is not clear on this point. Some authors have adopted a literal interpretation, stating that the call option for the redemption of shares could be admitted only to the company and to the shareholders other than the holder of redeemable shares. Others have judged this solution too rigid in a system which should be inspired by the free bargaining approach. Thus, they argue that the position of the holders of redeemable shares is symmetric to the position of the company and the other shareholders. As a consequence, the former may be entitled to exercise a put option, binding the company (or the other shareholders) to purchase their own shares. In giving a put option to redeemable shareholders, Article 2437-*sexies* would create an interesting distinction between rules governing share buy-back and share redemption. Furthermore, it would be possible to meet institutional investors' desires, because they see the redemption of shares as a way to exit from the company when they judge their investment no longer profitable. It can be argued that if legal practice followed this solution and if the courts saw it in accordance with Article 2437-*sexies*, the free bargaining approach could be safe. Otherwise, the introduction of redeemable shares is destined to remain a dead letter.

d. Time and Manner of Redemption

Article 2437-*sexies* does not specify whether the conditions of redemption have to be specified in the article of association and whether directors have the power to determine such conditions. In academic literature, these problems of uncertainty have not yet been studied. It is questionable whether they offer fertile soil for a debate on the balance between mandatory and default rules or whether they are destined to be solved by court actions. These deficiencies could represent a serious obstacle to the issue of redeemable shares in Italy, because investors will not be attracted to an equity instrument whose features are not regulated at all.¹⁴⁵

¹⁴⁴ MATTEO L. VITALI, *Pregiudizio degli azionisti di risparmio nelle operazioni di fusione*, in *Riv. Dott. Comm.*, 2004, p. 1114 ff.

¹⁴⁵ Italian authors agree that other problems are raised by the provision concerning redeemable shares. These problems can be summarised as follows. Article 2437-*ter* – incorporated by reference into Article 2437-*sexies* – provides for a shareholder's right to have its shares liquidated (redeemed) on retraction (paragraph 1). The value of such shares will be determined by the directors in agreement with the company's statutory auditors and the relevant firm of independent auditors. To this end, consideration must be given to: (i) the company's assets and liabilities; (ii) its projected revenues; and (iii) the fair value of the shares (if any). If the company is listed, reference will be made to the arithmetic mean of the relevant stock prices over the six months preceding the date of publication or receipt of the notice convening a general meeting at which a resolution should be taken to permit retraction. Still, share value

This general uncertainty is clearly visible in other provisions which Article 2437-*sexies* refers to. One of these provisions stipulates that

Shareholders are entitled to be notified the value of the shares as determined in accordance with the second paragraph of this article within fifteen days prior to the date of the general meeting, and each shareholder shall have the right to inspect, and draw copies of, such determination at his own costs.

Whether this provision may be extended to share redemption will depend on which body is identified as the agency empowered to exercise redemption. According to a preliminary interpretation, the general meeting seems to be responsible, by reference to Articles 2357 and 2357-*bis* of the Civil Code, for adopting a special resolution whereby redemption should be exercised. As a result, the redeemable shareholders must be made aware of the terms of such redemption within 15 days prior to the date of the general meeting. Yet, a different view holds that the agency duly empowered to exercise redemption rights can only be the company's managing body, precisely because of the managerial character of such a move. This view seems to emphasise the distinction between the issuance of redeemable shares and the exercise of the right of redemption by the company.

In this case, the balance between a flexible and rigid system turns into the identification of the internal organ competent to exercise the redemption.

D. Summary

Share redemption offers a prolific field of comparison, because it involves several interests not only from a company's perspective but also from the point of view of shareholders and creditors. At this point, it is possible to summarise the observations made in this article.

Firstly, the common law seems inclined to accept a wide power of redemption for companies. This is probably a consequence of the sophistication of UK capital markets.

Secondly, the terms and manner of redemption set out by section 159 CA are interpreted by judges and lawyers in the most flexible way. In this respect, not only the waiver of section 159 [A] CA, but even legal practice has played an important role.

Thirdly, the flexibility of the rules governing share redemption seems to decrease only when it faces creditors' interests and capital consistency. This is probably due to the binding provisions of the Second Directive and to the consequent caution of the courts. Although it is conceivable that the forthcoming Second Directive's reform would change the position of the judges on this point, many UK authors have suggested that creative equity financing cannot be frozen by rules requiring minimum capital.¹⁴⁶

Fourthly, with regard to the regulation of share redemption, the UK system seems to have exploited all interstices left by the Second Directive in national laws. The rules governing share redemption in Italy do not seem equally flexible, even if Article 2437-*sexies* states that shareholders are free to shape the features of this class of shares in the articles of association. Even if these rules are inspired by the free bargaining approach, they do not completely reflect its ratio. One piece of evidence may be found in the fact that Article 2437-

determination criteria at variance with the statutory criteria may autonomously be set out by the company in its articles of association. Finally, the shareholders are entitled to be notified of the applicable settlement value within 15 days prior to the meeting date.

¹⁴⁶ J. ARMOUR, *Capital Maintenance* <http://www.dti.gov.uk/cld/esrc6.pdf>; and DTI, *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* (June 2000) <http://www.dti.gov.uk/cld/capm.pdf> Part II pages 9 – 15; J. RICKFORD, *Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance*, 2004, *European Business Law Review*, 1 (available from <http://www.bjicl.org/index.asp?contentid=665>).

sexies does not make clear whether the holders of redeemable shares are entitled to activate the redemption right and, consequently, if they are entitled to sell their shares to the company or to the other shareholders. The wording of the rule seems to give a call option for the purchase of the redeemable shares only to the latter.¹⁴⁷ Another argument against flexibility is well represented by the lack of any provisions concerning the time and manner of redemption. From a company law reform perspective, the lawmakers' intervention is urgently required on this point, because the law is completely silent and an exercise in balancing mandatory and default provisions is also required by scholars and practitioners. From a practical point of view, this deficiency might cause the institutional investors and private equity funds to lose interest in purchasing redeemable shares and, consequently, in financing companies looking for fresh midterm finance.

At this point, two conclusions may be drawn. Firstly, it is doubtful whether the Italian system has transplanted the UK model properly. As recently argued by a commentator, with reference to the equity finance rules, the free bargaining approach cannot be transplanted uncritically and the adoption of such a model does not relieve lawmakers of the task of balancing and establishing easily interpretable rules.¹⁴⁸ Secondly, at least with relation to the topic considered here, there is not a perfectly coincident and level playing field between the UK and Italian systems, even though the EU Directives tend to harmonise Member States' legislation.

In the final part of this article, further evidence of these statements will be considered and an evaluation of the topic will be proposed.

V. Conclusions: Convergence versus Harmonisation in Equity Finance

Is there a genuine level playing field in equity finance between the UK and the Italian systems? Do the EU Directives on company law – and, for the purposes of this work, the Second Directive in particular – present any obstacles to the implementation of the free bargaining approach? Is the harmonisation, sponsored by the EU, compatible with the free bargaining approach and with a market for rules governing equity financing?¹⁴⁹ Is the financial structure sufficiently well governed by default rules alone or should mandatory rules play a role in attracting investors?

¹⁴⁷ See *supra* Part IV, Section B 2 b. One common interpretation of Article 2437-*sexies*, among Italian scholars, is that only the company and the other shareholders, for instance those who do not hold any redeemable shares, are entitled to redeem shares. See A. PACIELLO, *Art. 2437-sexies – Azioni riscattabili*, *loc. cit.*

¹⁴⁸ See M. VENTORUZZO, *Experiments*, *loc. cit.*

¹⁴⁹ TJIONG, HENRI, *Breaking the spell of regulatory competition: reframing the problem of regulatory exit*, (August 2000), MPI Collective Goods Preprint No. 2000/13, <http://ssrn.com/abstract=267744>. (Generally, the European Commission perceives regulatory differences to be undesirable as it will interfere with the common market or result in-what is seen as-unfair competition. Hence, the Commission has embarked upon harmonization commonly without reference to the scale of economic arbitrage to be expected. We may observe this from Commission efforts in fields as disparate as taxation (where economic arbitrage is very much prevalent) and social or environmental regulation (where economic arbitrage is much less strong). It seems that regulatory competition plays a role only in so far as it allows the Commission to construct it as a credible threat to the ability of individual member state governments to pursue national policies unilaterally. The political use of the regulatory competition argument in this way seems to favour cooperation rather than competition.) Read also M. VENTORUZZO, *La responsabilità da prospetto negli Stati Uniti d'America tra regole del mercato e mercato delle regole*, 2003, Milano, at p. 150 ff.

It is not easy to answer to all these questions, even though the problems concerning companies' financial structure discussed in this article may have helped to make the topic clearer.

It is hoped that some additional comments below will serve to clarify these issues further.

A. Contractual Freedom in the Company Law Reform Movement in Europe?

Two recent empirical studies show that only a flexible legal system could safeguard corporate efficiency and, at the same time, an acceptable level of protection for investors.¹⁵⁰ It has been argued that this could be reached only with two factors: an adaptable legal system on the basis of default rules and a high rate of statutory legal change. However, it is questionable as to whether some EU Member States – which will be briefly considered below – such as France, Spain, and Portugal have reached a satisfactory level in the balance between mandatory and default rules for corporate financial structures. The example of Italian company law, concerning classes of shares and share redemption, makes it clear that it is often not enough to adopt the free bargaining approach as the ratio of company reform for providing real flexibility to firms and investors. The preservation of several mandatory rules does not combine well with the adoption of the principle of atypicalness in the creation of a class of shares, because these rules may cause interpretative and litigious uncertainty. Naturally, investors may be deterred by such a situation and refuse to invest money in sophisticated equity instruments. It is too early to give a definitive opinion on the new rules on equity finance in Italy, but somewhat pessimistic evidence is apparent in the experience of other Member States.

In France, the law of 24 July 1966 on commercial companies has always been considered too rigid. The introduction of a new corporate form in 1994 – *Société par actions simplifiée* – represented an important turning point, because it moved from detailed rules, leaving little discretion to the shareholders, towards a system entirely based on contractual freedom. As reported in a recent study,¹⁵¹ this new approach has earned approbation from the market, because at least 40,000 companies have incorporated this form of business over the last few years. Moreover, the financial structure of the companies has been the target of the law reforms. The need for new, flexible rules was due to two factors. The first one was that a number of French financial institutions were obliged to operate in the United States in order to issue equity instruments such as preference shares. The second factor was the rigid classification of the hybrid securities that could be classified only as equity.¹⁵² These factors brought about the introduction of a new class of shares in 2004. French law now offers the possibility to issue preference shares as well as to let bylaws determine the features of these shares. In particular, (i) the terms of conversion and redemption may be set by the articles of association; (ii) listed companies can redeem the preference shares if the market is not liquid; and (iii) parties can decide whether or not to attach to these shares voting rights (also of subsidiary companies), financial rights (as priority dividend or repayment, or the right of conversion into ordinary shares) or administrative rights (as a special right to receive more information concerning the financial situation of the company from the board of directors). Nevertheless, the freedom of contract is not complete. With reference to preference shares, it

¹⁵⁰ The first study referred to is K. PISTOR, YORAM KEINAN, J. KLEINHEISTERKAMP AND M.D. WEST, *Innovation in Corporate Law*, in J. Comp. Econ., 2003, downloadable on www.ssrn.com/abstract=419861. This paper was criticised by M. VENTORUZZO, *Experiments*, *cit.*

¹⁵¹ See J. SIMON, *The new French Company Law: between freedom of contract and mistrust*, in www.universita-bocconi.it.

¹⁵² See J. SIMON, *The new French Company Law*, *loc. cit.*

has to be noted that: (i) the general meeting provides the context for decisions on the issuance, redemption and conversion of preference shares and this power may only be delegated to the board of directors; and (ii) preference shares may not account for more than one half of the share capital in unlisted companies and one fourth in listed companies.

The Spanish situation is very similar to the French one. In 2003, the lawmakers introduced a second type of limited liability company, the *Sociedad Limitada Nueva Empresa*. The free bargaining approach in the creation of this new kind of company was evident: the law allows the electronic incorporation of the company without the presence of a public notary that is usually necessary. Nevertheless, this intervention was deeply criticised by certain academic authors, because it imposes some limits on contractual liberty. First, a company's founders cannot choose the name of their company, because the company name has to be made up of the name and surname of one of the company's founders and should consist of an alphanumeric string. Second, the initial number of the founders is limited to five. Third, the initial capital of the company is quite high – EUR 120,202 – and the founders cannot contribute in kind but only in cash. Fourth, the directors of the company can be chosen only among the shareholders.¹⁵³ Spanish rules on corporate financing have become more liberal in the last few years. The intervention has been particularly incisive with regard to the class of shares that a company can issue. The Spanish system can be described as follows. There are two kinds of shares, the common shares and the privileged shares. The latter class can be featured in different ways. Consequently, Spanish company law recognises normal privileged shares, non-voting shares, and redeemable shares. The tracking stocks are not provided by the recent reforms, even if many authors have tried to demonstrate their utility as well as supported their enforcement.¹⁵⁴ The need for midterm intermittent financing was satisfied in 1998, when the reformed *Ley de Sociedades Anonima* introduced redeemable shares.¹⁵⁵ This class of shares can be featured with a call or a put option in a way that permits the company, shareholders or both to buy or to sell the shares.

Despite the fact that this new class of shares shows how the new statutory rules on company law can be in accordance with the free bargaining approach, there are some problems. Firstly, the redeemable shares can be issued only by listed companies. Consequently, unlisted companies can reach similar results through shareholders' agreements on the one hand, but, on the other hand, are bereft of an important instrument of equity finance. Secondly, Spanish company law provides for a specific limit of issue: the redeemable shares can be issued for only up to 25% of the legal capital. Thirdly, given that where the company has a call option, it cannot exercise it for a three-year period, it is evident that also the arrangement of the put and/or call option attached to the redeemable shares suffers some limits. Finally, all these problems are reflected in the narrow use of this class of shares by Spanish companies.¹⁵⁶

Some problems finally occur even with the Portuguese model. Article 302 (1) of the Code of Commercial Companies of 1986 (CCC) states that "the article of association may create classes of shares which confer differing rights." This formula seems to be inspired by the free bargaining approach, because it allows companies to shape equity instruments in such a way as to satisfy the shareholders' will. Portuguese company law provides for: (i) non-

¹⁵³ See I. FERRANDO, *Evolution and Deregulation in Spanish Corporate Law*, on www.uni-bocconi.it.

¹⁵⁴ J.J. HASS, *Directorial fiduciary duties in a Tracking Stocks Equity Structure: the Need for a Duty of Fairness*, 94, *Michigan Law Review*, 1996, 2089; A. CHANG, *Tracking Stock: Structure and Corporate Governance Issues*, 21, *Companies and Securities Law Journal*, 2003, 279; I. FERRANDO, *Evolution and Deregulation*, *cit.*

¹⁵⁵ Article 92 *bis* and *ter* LSA.

¹⁵⁶ It seems that only two companies have used redeemable shares in Spain, since their introduction (Indra Sistema S.A. and Sociedad General de Aguas de Barcelona S.A.).

voting preference shares, which deprive the shareholders of the voting rights, enabling them with a priority dividend; (ii) redeemable shares; and (iii) reimbursed shares which follow the amortisation of a part of share capital and its repayment to the shareholders. Despite the formula adopted by the statutory rules, the freedom of contract seems not to be complete in Portugal. It has been noted that limits are evident both in the case of voting and economic rights. With regard to voting rights, statutory law does not expressly allow companies to issue the class of shares characterised by a peculiar conformation of voting rights attached to them or carrying limited voting.¹⁵⁷ With respect to economic rights, Portuguese law does not have any provisions concerning either shares for employees or tracking stocks. Despite the contents of Article 302 CCC, it has been observed that

[c]onsidering that such rules are, by and large, of an imperative nature, and that control rights regarding the core operations of corporate finance are directly prescribed by statutory law, thus not allowing a significant margin for reallocation by private decision of shareholders, one may consider that the Portuguese legal system contains strong mandatory rules.¹⁵⁸

B. The UK Model: Has the Gap Been Completely Filled?

This paper has shown that UK rules of equity financing are very flexible and leave shareholders to shape the equity financial instruments in a way they consider more efficient. It has also been demonstrated that the UK system is more flexible than that of other EU member states. Several authors agree that the UK system should be free to arrange a system based on the free bargaining philosophy, although the obligations at the EU level seem not to make this goal easily attainable.¹⁵⁹ In fact, the obligation to comply with EU Directives does not allow the United Kingdom to follow the route of other common law countries in reforming their company law. Another reason for this situation is that the EU harmonisation programme relies on mandatory rules.¹⁶⁰ even though a more flexible approach has recently been observed at this level.¹⁶¹ The flexibility of the UK system has in any case increased through the introduction of treasury shares.¹⁶² In this way, the UK seems to have filled the gap as well as exploited the room left by the Second Directive¹⁶³ for the free bargaining approach. Sections 162 [A]-162 [G] CA 1985 now permit companies to hold and subsequently dispose of their own shares rather than require the automatic cancellation of such shares.¹⁶⁴ The introduction of treasury shares has realised four goals. Firstly, companies are now able to redress the debt/equity ratio avoiding costs due to a new issue of shares. Secondly, using a broker to resell treasury shares in small lots can be a way to avoid underwriting costs. Thirdly, shares held as treasury equity give companies the chance to invest in their own shares if the return from doing so is higher than other business operations or projects. Fourthly, employee share

¹⁵⁷ As, for example, a class of shares which consents to vote only on predetermined subjects).

¹⁵⁸ See JOSÉ E. ANTUNES, *An Economic Analysis of Portuguese Corporation Law- System and Current Developments*, on www.uni-bocconi.it.

¹⁵⁹ See *supra* note 48, at p. 5; V. EDWARDS, *EC Company Law*, Oxford, Clarendon Press, 1999, at p. 11 and R. BUXBAUM and K. HOPT, *Legal Harmonization and the Business Enterprise*, 1998, at pp. 235-236.

¹⁶⁰ R. PENNINGTON, *Pennington's Company*, *cit.*

¹⁶¹ *Centros*. See, inter alia, V. EDWARDS, *Freedom of establishment under the EC Treaty and the effect of centros*, 2000, *Company Financial and Insolvency Law Review*, at p. 542 ff.

¹⁶² DEPARTMENT OF TRADE AND INDUSTRY, *Share Buy Backs: a Consultative Document*, 1998; V. KNAPP, *Treasury shares. The practicalities*, in *Practical law companies*, 2004, p. 15-20; P. GRAHAM, *Treasury shares*, in *Company Secretary's Review*, 2003, p. 142; G. MORSE, *The introduction of treasury shares into English law and practice*, in *Journal of Business Law*, 2004, p. 303- 331.

¹⁶³ The Second Directive allows Member States to adopt treasury shares.

¹⁶⁴ But section 162 [D] allows companies to cancel shares that are held as treasury shares.

schemes can potentially be managed more efficiently.¹⁶⁵ Nevertheless, the development of the UK model of equity finance towards total freedom in financial matters seems not to be complete, although – in relation to classes of shares – it seems to be more modern than the systems of other European countries. As argued by several scholars, some rules are seen as particularly cumbersome for a modern equity finance system. Firstly, the capital maintenance doctrine¹⁶⁶ has been considered as inefficient. According to this view, the Second Directive does not pursue the goal of creditors' and shareholders' protection despite its mandatory nature.¹⁶⁷ Secondly, bodies set up for the review of company law as well as scholars have judged shares with par (or nominal) value an outmoded concept.¹⁶⁸ Finally, it has been shown that a reform, even of the financial assistance banned by section 151 CA, is necessary.

C. Final Evaluation

The contractarian vision seems to be widespread both in both the UK and in some other European countries. This approach (and its variants) may create a demand for rules governing equity finance, with companies free to select the most efficient rules among those offered by the statutes. This approach now seems to have been transplanted into the European framework as the more efficient way for granting economic efficiency and competition among statutes, allowing companies to choose the rules that they judge more adapted to their exigencies. This trend in building new statutes could be based on the fact that, at a European level, some obstacles to increasing equity capital were in evidence. For example, this is the case with Article 7 of the Second Directive which does not allow obligations to perform work or supply services to be used as a consideration for the acquisition of new shares.¹⁶⁹

The UK model seems to have predated that of the other European countries, even if its journey towards complete freedom of contract is not yet complete. There may be several reasons for this, and it is not within the scope of this article to detect them all. Certainly, the adoption of a flexible model in equity finance, such as the United States one, is highly controversial in the UK. Probably, implementation of this model will not be possible because of the EU Directives. These Directives drive towards a model characterised by mandatory rather than default rules. Moreover, the role played by the courts is essential for granting a high degree of flexibility as has been observed in the analysis of the concepts of classes of shares and share redemption. Nevertheless, judges seem to be reluctant in shifting the balance towards default rules where third parties' interests are involved, as *Barclays* clearly shows. But it has also to be considered that other Member States, with a civil law background, do not have such an important player as the common law which may balance mandatory and default rules. Another reason of the flexibility of the UK system may be the role played by institutional investors. The journey of the UK to complete freedom of contract in equity finance will probably only reach its destination if the EU resolutely shifts the balance between the rules governing the financial structure towards a more flexible system: the amendment of

¹⁶⁵ G. MORSE, *The introduction*, *loc. cit.*

¹⁶⁶ See the principles established by *Trevor v Withworth* (1887), 12 App Cas 409, HL.

¹⁶⁷ See J. RICKFORD, *Reforming Capital – Report of the Interdisciplinary Group on Capital Maintenance*, (2004), 15, *European Business Law Review*, pp. 919-1027; J. RICKFORD, *Reforming Capital: An Introductory Note*, (2004), 15 *European Business Law Review*, p. 1029-1030; P. LEYTE, *The regime of capital maintenance pertaining to public companies, its reforms and alternatives*, 2004, 25(4), *Business Law Review*, p. 84-92.

¹⁶⁸ See E. FERRAN, *Creditors' interests and core company law*, (1999), 20 (10), p. 314-323.

¹⁶⁹ See F. KLÜBER, *The rules of capital under pressure*, *cit.*, at p. 108.

the Second Directive offers a new opportunity for a more decisive liberalisation of the equity finance system.¹⁷⁰

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¹⁷⁰ See P. DAVIES, G. HERTING AND K. HOPT, *Beyond the Anatomy*, in *The Anatomy of Corporate Law – A comparative and Functional Approach*, edited by REINER R. KRAAKMAN, P. DAVIES, H. HANSMANN, G. HERTING, KLAUS J. HOPT, HIDEKI KANDA, EDWARD B. ROCK, (Oxford 2003), at p. 215 ff.