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Law for Directors & Managers

Lecture 5



Capital Pledging of Share Capital & Capital Maintenance

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ADVOCATES

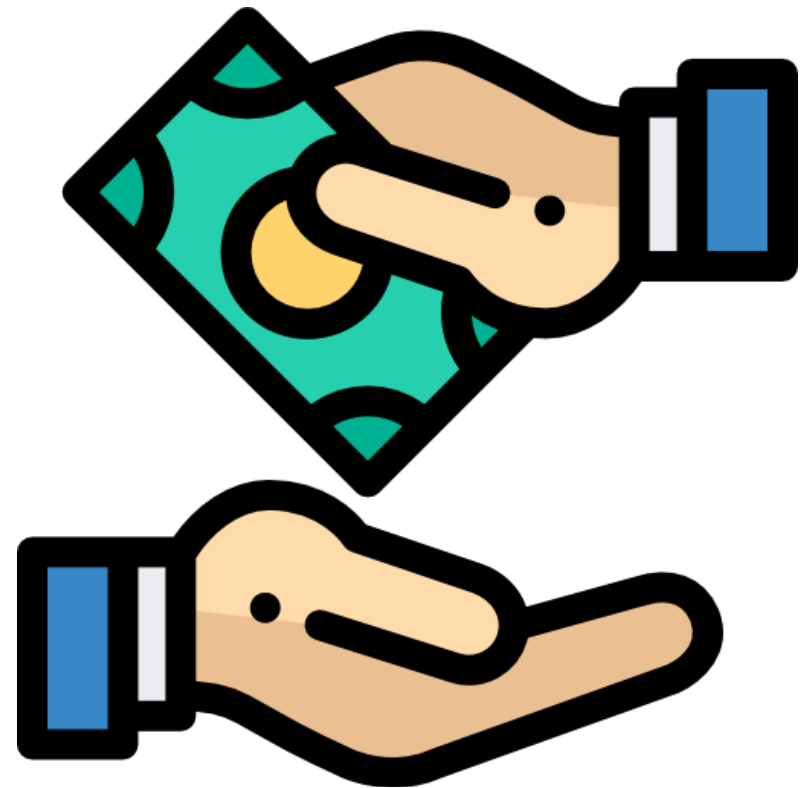
Pledging of Shares



Introduction

A pledge over shares confers upon the pledgee (that is, the creditor) the right to obtain payment out of the shares with privilege over other creditors. The debt due to the pledgee constitutes a privileged debt over the pledged shares.

Article 122 of the Companies Act



Public and Private companies

Public company

Shares in a public company may generally be pledged unless otherwise provided in the M&As of the company or under the terms of issue of the shares.

Private company

In the case of a private company, shares may not be pledged unless the M&As of the company specifically allow it.

Publication of the Pledge



- The company needs to be notified of the shares being pledged within **14 days of the granting of the pledge**
- Notice of the pledge must also be delivered to the Registrar **within 14 days (From T(2))**
- The company whose shares have been pledged should also record the pledge in the register of members

The pledge is not regarded as effective until the registration by the Registrar of the notice of the pledge.

Terms of the Pledge Agreement

The pledge agreement may specify who is to exercise all the rights belonging to the shareholder during the duration of the pledge, including voting rights and dividend payments.

If the pledge is silent:

1. All rights of the holder of shares will be exercised by the pledgor until such time as he defaults under the agreement of pledge or until the pledgee enforces his security;
2. Unless the pledgor and the pledgee have otherwise agreed in the pledge agreement, dividends or interests payments due on securities which are pledged shall be paid by the company to the pledgee who shall appropriate any such amounts received to the interest due on the debt secured by the pledge, and, if there is an excess, to the capital.

Deliverables of the Pledge Agreement

1. Undated share transfer instruments;
2. Undated director resignations;
3. Annotated share transfer instruments;
4. Notice upon an issue of shares
5. Undertaking that any further shares so issued will be pledged and annotated share certificates and undated share transfer instruments would be delivered to the pledgee.

Termination of the Pledge

Notice of termination should be delivered by the pledgee to the Registrar within **14 days** from the termination (Form T3).

- The company and the regulated market, if applicable, should also be notified of the termination.

Transfer of pledged shares

Any transfer or assignment of the pledged shares without the **consent** of the pledgee is null and void.

If consent is given, the transfer or assignment will be valid but the shares will remain subject to the pledge.



Payment out of the shares pledged

The creditor has both the right to apply for a judicial sale of the shares as well as the right to dispose or appropriate the shares in the even of a default under the agreement of the pledge.

The pledgee is obliged to notify the pledgor prior to this by means of a judicial act.

Price of shares to be disposed of or appropriated

The value of the shares may be established by agreement between the pledgor and the pledgee as long as this is done **after** notice of default would have been given.

Failure to reach agreement the value will be determined by a certified public accountant or an auditor appointed by the Court on the application of the pledgee.



Shares quoted on a stock exchange

1. Notification to the recognised investment exchange

Certified true copy of the pledge agreement must be notified to the exchange within 14 days + notice to the company

2. Transfer of shares throughout the pledge

Any transfer of shares is null and void (notwithstanding consent of the pledgee!)

3. Enforcement of pledge

In the event of a default under the agreement of pledge and upon giving notice by judicial act to the pledgor, the Maltese regulated market and the company, the pledgor must have the securities sold through a person duly licensed under the Investment Services Act

Additional conditions for pledge of shares

Prior to exercising the right to dispose of or appropriate the shares, the pledgee must offer the shares to the other shareholders of the company as follows:

- If the M&As of the company lay down pre-emption rights relating to the transfer of shares, then the shares must be offered by the pledgee in accordance with those rights
- If not, the shares must be offered by the pledgee to all the other shareholders of the company in proportion to their holdings.

In the case of a **public company** the pledged shares have to be offered to shareholders of a company on a pre-emptive basis only if the M&As of the company include pre-emption rights.

Financial Collateral Regulations

- These regulations apply to collateral arrangement constituted over cash, instruments and credit claims.
- They apply to certain entities (credit institutions, insurance undertakings, investment services providers, financial institutions and non-natural persons in certain circumstances).
- Abolishes many formal requirements, improves enforcement rules, in or outside insolvency.

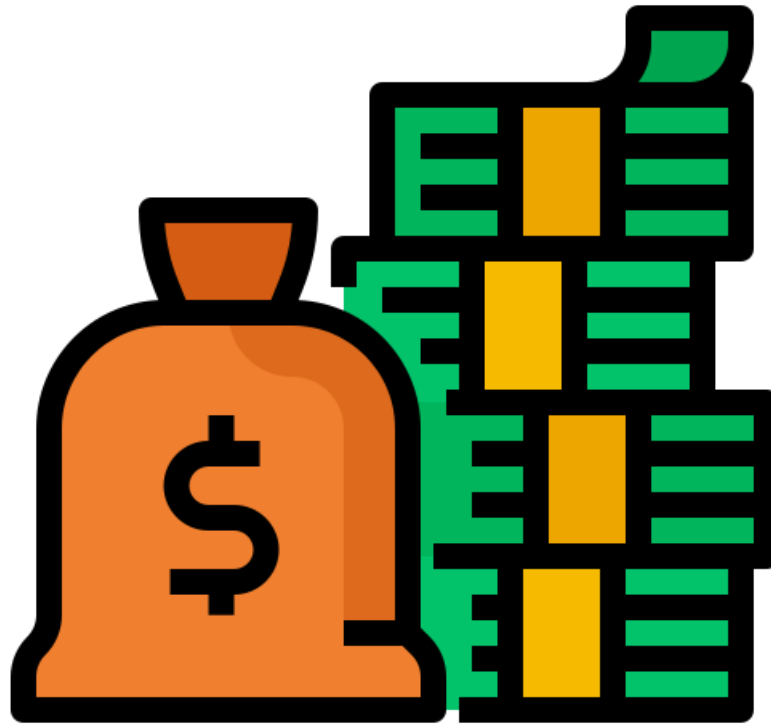
Financial Collateral Regulations – noteworthy provisions

1. A financial collateral arrangement is valid in accordance with its terms
2. Pre-emption rights in the Companies Act do not apply
3. Enforcement is made without formal requirements
4. Enforcement takes place notwithstanding insolvency

Financial Collateral Regulations – enforcement

Financial collateral arrangement shall **be valid and enforceable in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider or collateral taker.**

Capital Maintenance



Introduction

The single greatest advantage of trading through a company is the limited liability afforded to its members.

In order to secure this advantage, companies face additional disclosure requirements and have to follow the rules on **capital maintenance, which prevent the members withdrawing their capital without restriction.**



Capital Maintenance Doctrine

The doctrine is primarily intended for the protection of creditors but, it is also designed to protect shareholders, present and future, against action by directors, which might covertly diminish the value of their shares as long term investment.

Definition of maintenance of share capital

There is no universally acceptable meaning to the phrase 'maintenance of capital'. Different views have been put forward.

But generally, the capital maintenance doctrine should be seen as a means of protecting creditors against the risks associated with limited shareholder liability.

Maltese law and the Capital Maintenance Doctrine

In the **first place**, the law cannot altogether prohibit a company from parting with assets even where the value of the remaining assets is less than that stated in the balance sheet as being the value of the capital.

Secondly, since the underlying aim of the capital maintenance rules is the protection of the interests of the company's creditors, Maltese capital maintenance rules regulates the extent to which a company may return its issued share capital to its shareholders.

The rules making up the Capital Maintenance Doctrine

1. A company may not purchase its own shares or redeem its preference shares except under the strict conditions laid down by law;
2. A company may not give any kind of financial assistance for the acquisition of its own shares except in the particular circumstances set out in the law;
3. Dividends may only be paid from the distributable profits of the company; and
4. As a rule, a reduction of share capital can only be effected subject to certain strict conditions;



1. Share repurchases



ARTICLE 105: GENERAL RULE

- Prohibition from subscribing to own shares
- Actions to the contrary will have consequences.

ARTICLE 106: EXCEPTION

- A company may acquire its own shares other than by subscription, as long as a number of stringent conditions are followed.

ARTICLE 107: BUY-BACK OUTSIDE THE SCOPE OF ART.106

- This article allows for special circumstances where the company may acquire its own shares other than by subscription, and may do without most of the conditions mentioned in art.106.

1. Share repurchases

ARTICLE 105: GENERAL RULE

The consequences of a breach is not such that it renders the subscription void but that joint and several liability is imposed (i) on the subscribers to the memorandum (where the subscription takes places on original subscription) and (ii) on the members and directors (where the company subscribes to the shares on an increase in the issued share capital). No liability will attach if the member or director can prove that the breach occurred through no fault of his own.

1. Share repurchases

ARTICLE 105: GENERAL RULE

Should a company subscribe for its own shares in contravention of Article 105:

- If the shares were subscribed to on original subscription, the members of the company will be jointly and severally liable to pay for the shares subscribed in contravention of the article;
- In the case of an increase in the issued share capital, the members and directors shall be liable jointly and severally to pay for the shares subscribed in contravention of the general rule provided that any member or director may be released from such liability if he proves that the breach occurred through no fault of his own.

In view of the above, the effect of contravention of the provision in the Companies Act prohibiting the subscription of shares is not nullity.

1. *Share repurchases*

ARTICLE 106: EXCEPTION

A company “may acquire its own shares other than by subscription” **as long as a number of stringent conditions are followed:**

- _ The Memorandum or Articles must authorise the company to acquire its own shares;
- _ Authorisation is given by an extraordinary resolution (which must be registered with the MBR)

1. *Share repurchases*

ARTICLE 106: EXCEPTION

A company “may acquire its own shares other than by subscription” **as long as a number of stringent conditions are followed:**

- _ The Memorandum or Articles must authorise the company to acquire its own shares;
- _ Authorisation is given by an extraordinary resolution (which must be registered with the MBR)

1. *Share repurchases*

ARTICLE 106: EXCEPTION

- The nominal value of the acquired shares, including shares previously acquired and held by the company may not exceed 50% of the issued share capital
- The company may not acquire its own shares when on the closing date of the last accounting period the net assets as set out in the company's annual accounts are, or following such distribution, would become, lower than the amount of the called up issued share capital plus those reserves which may not be distributed under the provisions of the Companies Act or the company's memorandum or articles
- The shares acquired must be fully paid-up shares

1. *Share repurchases*

- _ In any case, a company may only acquire its own shares out of the proceeds of a fresh issue of shares made specifically for the purpose, or out of profits available for distribution, and
- _ Insofar as profits available for distribution are concerned, Article 192 (3) of the Companies Act provides that a company's profits available for distribution shall be its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of issued share capital duly made.
- _ A company may not as a result of the acquisition of its shares become the only holder of its ordinary shares.

1. Share repurchases

ARTICLE 107: BUY-BACK OUTSIDE THE SCOPE OF ART.106

A company may acquire its own shares other than by subscription and may do without most of the conditions mentioned in art.106 – **the only prohibition being that the company may not become the sole holder of its ordinary shares.**

Within these special circumstances, the company is allowed to hold on to the shares for a 30 month period which starts to lapse from the date of acquisition.

If the company fails to dispose of the shares within this period, it is bound to pass an extraordinary resolution cancelling the shares.

1. Share repurchases

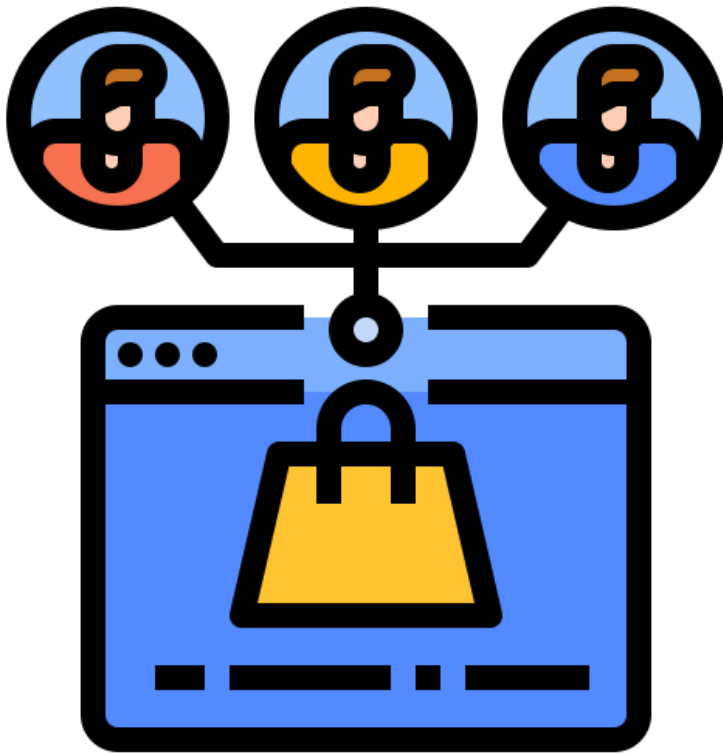
Article 107 of the Companies provides for **8 circumstances** in which the company may acquire its own shares without the need to comply with any of the conditions set out in Article 106:

1. Where the shares are acquired by the company in the course of a reduction of the issued share capital;
2. Where the shares are the subject of an application to purchase shares in a public company and such application to subscribe for shares is revoked
3. Where the shares are forfeited or surrendered to the company
4. Where the shares are acquired in any procedure for the conversion, amalgamation or the division of companies

1. *Share repurchases*

5. Where the shares are acquired in any procedure for the change of status from a private to a public company or vice versa
6. Where the shares are acquired by the company pursuant to a court order made for the repurchase of shares held by dissenting shareholders in a change in status from a public to a private company or held by dissenting shareholders in companies involved in a conversion, amalgamation or division or where the shares are acquired by the company pursuant to a court order made in connection with an action by a member claiming unfairly prejudicial conduct
7. Where the shares are fully paid up and acquired by an investment company with fixed share capital or by another company forming part of the same group at the member's request provided that such acquisitions will not have the effect of reducing the company's net assets below the amount of the issued share capital plus any reserves the distribution of which is forbidden by law;
8. Where the shares are acquired by the company during a redemption of redeemable preference shares.

1. Share repurchases



RE-PURCHASE OF REDEEMABLE PREFERENCE SHARES

It is also possible to purchase redeemable preference shares. The law provides that shares may be bought back without any distinction and there is no other prohibition set out in terms of the Companies Act.

1. Share repurchases

REASONS FOR SHARE BUY-BACKS

1. To return value to shareholders
2. To reduce the share capital
3. Raising capital from outside sources
4. Deadlock situation between shareholders

2. Financial assistance



Previously, art.110(1) held that it is unlawful for a company to subscribe for, hold, acquire or otherwise deal in shares in a parent company. It was also prohibited for any company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of an acquisition or subscription made or to be made by any person of or for any shares in the company or its parents company.

This prohibition was slightly reduced in respect of private LLC, with the introduction of sub-article (4) of art.110.

3. Dividend distributions



It is only out of distributable profits that dividends may be paid.

Distribution is defined as *“every description of distribution of a company’s assets to its members, whether in cash or otherwise”*.

Dividend distributions

Private company

“Profits available for distribution”: a company’s accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of issued share capital duly made.

Dividend distributions

Private company

“Profits available for distribution”: a company’s accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of issued share capital duly made.

Dividend distributions

Public company

Additional condition:

A public company may only make a distribution at any time –

- (a) if at that time the amount of its net assets is not less than the aggregate of its called-up issued share capital and undistributable reserves; and
- (b) (b) if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate

Reduction of share capital



4. Reduction of share capital



Since the process of reduction of share capital is another fundamental rule of capital maintenance, one is prima facie led to believe that the law prohibits such a process.

However, this is not the case and since there are various reasons why a company would want to reduce its share capital, the law has set out a number of conditions with which a company must abide in order to be able to reduce its share capital.

Why would a company want to reduce its issued share capital?

1. A reduction of share capital can be made to offset losses, with the effect that distributable reserves of a company will be positively effected. It creates a reserve which is treated as a realised profit for accounting.



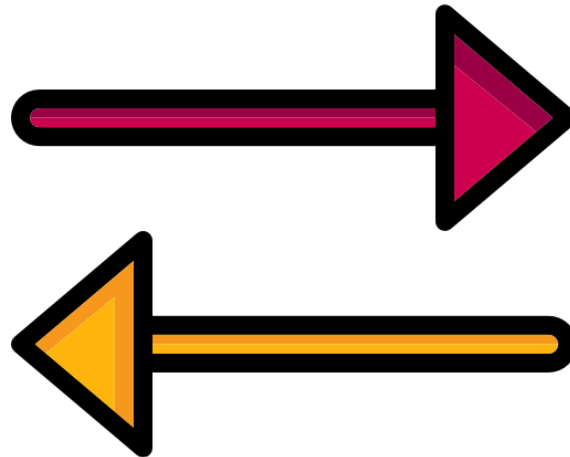
Why would a company want to reduce its issued share capital?

2. To return surplus capital



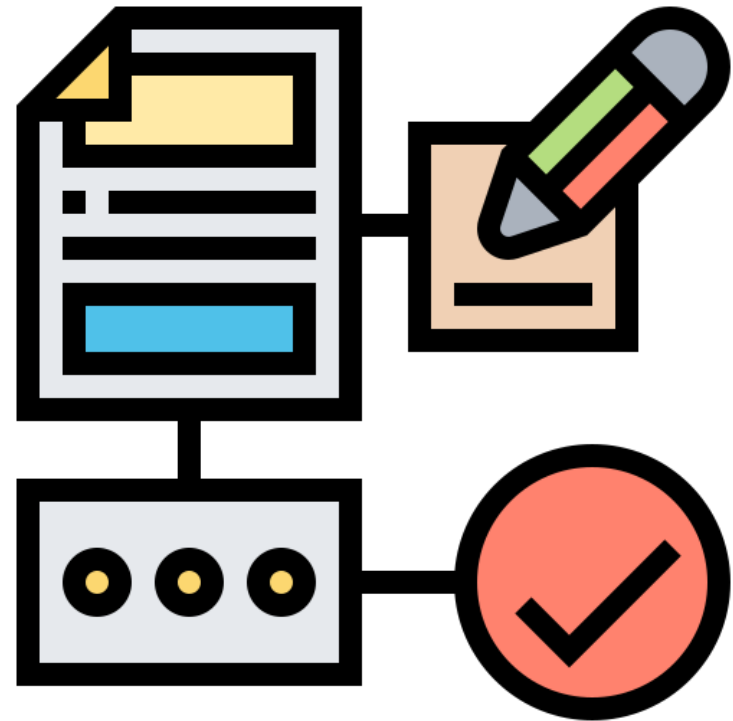
Why would a company want to reduce its issued share capital?

3. To facilitate a share buy-back or a redemption



Capital reduction procedure (Art.83)

1. The reduction must be permitted
2. An extraordinary resolution must be passed to approve the reduction
3. The reduction takes effect only after 3 months from the date of a publication of a statement on the deduction in the Government Gazette or on the website maintained by him and in a daily newspaper, that he has received the resolution for registration





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