

Equity and Debt Capital

Chartered Accountancy Corporate Level Corporate Law (LAW)

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EQUITY AND DEBT CAPITAL

Capital is the company's fund available for use in the business and represented by its assets. A company's capital consists of,

1. Share capital (Equity Capital) - money raised from shareholders
2. Debt Capital / Loan capital (Debentures) - money raised from lenders

SHARE CAPITAL (EQUITY CAPITAL)

It is the shareholders' investment in the company. To raise capital, the companies divide their capital into a number of small units. These units are known as 'shares'. Those who buy shares are known as 'shareholders' and they are treated as the owners of the company.

Nature of Shares (Section - 49)

- A share shall be movable property.
- No share shall have a nominal or par value.
- A share is transferable in the manner provided for by the articles of the company and such articles may limit or restrict the extent to which a share is transferable.

Types of Shares (Section - 49)

A company may issue different classes of shares, and in particular may issue shares which—

- (a) are redeemable;
- (b) confer preferential rights to distributions; or
- (c) confer special, limited or conditional voting rights or confer no voting rights.

Therefore, the shares of a company can be

- Ordinary Shares
- Preference Shares
- Deferred Shares
- Non-voting Shares
- Redeemable Shares

Rights Attached to Every Share - (Section - 49)

As per sec.49, subject to the company's articles, a share in a company shall confer on the holder –

- (a) The right to one vote on a poll at a meeting of the company on any resolution;
- (b) The right to an equal share in dividends paid by the company;
- (c) The right to an equal share in the distribution of the surplus assets of the company on liquidation.

In addition to the above as per Sec.51 (2), the board may approve additional rights at the time of issuing shares as 'terms of issue'.

ISSUE OF SHARES

As per Sec.50, immediately following the incorporation of a company, the company shall issue to each shareholder named in the application for incorporation (Form 1), the shares to which that person is entitled.

Notice to the Registrar Regarding Issue of Shares - (Section - 51(4))

Within twenty working days of the issue of any shares (both initial shares and subsequent shares), the company shall give notice to the Registrar in the prescribed form (Form 6) of,

- (i) the number of shares issued;
- (ii) the amount of the consideration for which the shares have been issued;
- (iii) the amount of the company's stated capital following the issue of the shares;
- (iv) a copy of any **terms of issue** approved by the directors under sec. 51 (2).

Method of Issuing Shares (Section - 54)

A share is deemed to be issued when the name of the holder is entered on the share register, and such entry shall be made before filing form 6.

Matters to be Considered when Issuing Shares (Section - 51)

The board of a company may issue shares subject to-

1. the company's articles
2. the provision of Sec.52 in respect of consideration and
3. the provision of 53 regarding pre-emptive rights to new shares

Consideration for the Issue of Shares (Section - 52)

Before issuing any shares, the board shall decide the consideration for which the shares will be issued; and resolve that in its opinion that consideration is fair and reasonable to the company and to all existing shareholders. The consideration for which a share is issued may take any form, including

- (i) cash,
- (ii) promissory notes,
- (iii) future services,
- (iv) property of any kind or
- (v) other securities of the company.

Upon receipt of the consideration, the company shall within a period of twenty days, make an allotment of the shares.

Pre-Emptive rights to new issues- Existing Shareholders right to buy new shares (Sec. 53)

Subject to the company's articles, where a company issues shares which rank equally with or above existing shares in relation to voting or distribution rights, those shares shall be offered to the holders of existing shares in a manner which would, if the offer was accepted, maintain the relative voting and distribution rights of those shareholders. Such an offer shall remain open for acceptance for a reasonable period of time.

DISTRIBUTIONS

As per sec.529, "distribution" means

- (a) the direct or indirect transfer of money or property, other than the shares of a company, to or for the benefit of a shareholder; or
- (b) the incurring of a debt to or for the benefit of a shareholder, in relation to a share or shares held by that shareholder, whether by means of a payment of a dividend, a redemption or other acquisition of the share or shares, a distribution of indebtedness or otherwise ;

DIVIDENDS (Section - 60)

A dividend is a distribution out of profits of the company other than

1. an acquisition by the company of its own shares or
2. a redemption of shares by the company.

Procedure to be followed before making a Distribution (Sec.56)

Before a distribution is made by a company to any shareholder,

- (a) Such distribution shall be authorised by the board by way of a Board resolution
- (b) In the resolution the board should resolve that the board is satisfied that the company will, immediately after the distribution is made satisfy the solvency test
- (c) The board should obtain a 'Certificate of Solvency' from the auditors
- (d) The directors who vote in favour of the distribution should sign a certificate stating that in their opinion, the company will satisfy the solvency test immediately after the distribution is made
- (e) The distribution should be approved by the shareholders by an ordinary resolution.

A director who fails to comply with the above requirement shall be guilty of an offence and be liable on conviction to a fine not exceeding rupees two hundred thousand.

Recovery of Distributions (Section - 61)

If a distribution is made to a shareholder at a time when the company did not, immediately after the distribution, satisfy the solvency test, such a distribution may be recovered by the company from the shareholder.

In case it is unable to be recovered from the shareholders, every director who failed to ensure the procedure to be followed or who signed the certificate, will be personally liable to repay to the company, so much of the distribution as the company is not able to recover from the shareholders.

SOLVENCY TEST (SECTION - 57)

A company shall be deemed to have satisfied the solvency test, if,

- (a) it is able to pay its debts as they become due in the normal course of business; and
- (b) the value of the company's assets is greater than,
 - (i) the value of its liabilities; and
 - (ii) the company's stated capital.

Assets > the value of its liabilities + stated capital

In determining whether a company satisfies the solvency test, the board—

- (a) shall take into account the most recent financial statements of the company;
- (b) shall take into account circumstances the directors know or ought to know which affect the value of the company's assets and liabilities;
- (c) may take into account a fair valuation or other method of assessing the value of assets and liabilities.

MAJOR TYPES OF SHARE DEALINGS IN A COMPANY

Re Purchase of its own shares by a company (Section 64)

1. If the articles of the company permit and 2. if the acquisition is in the interests of the company then 3. with the approval of the board a company may re purchase any of its shares

REDEMPTION OF SHARES

Meaning of “redeemable” (Section - 66)

A share is redeemable if the articles of the company make provision for the redemption of that share by the company

- (a) at the option of the company (section 67);
Before the shares are redeemed at the option of the company, the board must resolve that the redemption is in the best interest of the company.
- (b) at the option of the holder of the share (section 68); or
Where a share is redeemable at the option of the holder of the share and the holder gives proper notice to the company requiring the company to redeem the share, such

redemption will take place on the date specified in the notice or if no date is specified, on the date of receipt of the notice.

- (c) **on a date specified in the articles** (section 69);

Where a share is redeemable on a specified date as set out in the Articles, the company shall redeem the share on that date.

Under redemption at the option of the holder of the shares and redemption on a date fixed in the Articles, the share is deemed to be cancelled on that date. From that date, the former shareholder ranks as an unsecured creditor of the company for the sum payable on redemption. It must be noted that their rights are not equal to the other creditors of the company.

Procedure after acquisition or redemption

As per section 63 (3) a share that is acquired or redeemed by the company shall be deemed to be cancelled immediately upon acquisition or redemption, and immediately following the acquisition or redemption of shares by the company, the company shall give notice to the Registrar of the number and class of shares acquired or redeemed.

Stated Capital (Section - 58)

Stated capital in relation to a company means the **total** of all amounts **received** by the company or due and **payable to the company**

- (a) in respect of the issue of shares; and
- (b) in respect of calls on shares.

Where a share is issued for consideration other than cash, the board shall determine the cash value of such consideration for the purposes of the stated capital.

REDUCTION OF STATED CAPITAL - (Section - 59)

- A company may reduce its stated capital by a **special resolution**.
- Before the stated capital is reduced **Public notice** of a proposed reduction should be given not less than **sixty days before the resolution** to reduce stated capital is passed.
- If a company
 - had issued redeemable shares which are redeemable at the option of the shareholder or on a fixed date or

- if the company is compelled to purchase its own shares under a minority buy out provision

and if the company does not have adequate profits or reserves to the said redemption or repurchase, the board may, after obtaining the auditors certificate of solvency, resolve that the stated capital of the company shall be reduced by the amount by which the company would so fail to satisfy the solvency test

- A company may agree in writing with a creditor of the company, that it will not reduce its stated capital below a specified amount without the prior consent of the creditor or unless specified conditions are satisfied at the time of the reduction. If stated capital is reduced in breach of any such agreement, such a reduction will be invalid and of no effect. *This is a protection available to long term creditors.*
- A company which has reduced its stated capital shall give notice of the reduction to the Registrar by way of Form 8, within ten working days of such reduction specifying the amount of the reduction and the reduced amount of its stated capital.

FINANCIAL ASSISTANCE IN CONNECTION WITH PURCHASE OF SHARES

Restrictions on giving financial assistance (Sec.70)

As per sec.70(1), a company shall not give financial assistance directly or indirectly for the purpose of or in connection with the acquisition of its own shares.

This rule may be based on two main reasons. One is that if the company failed and its money has been spent on funding purchase of its own shares, the company will be severely affected. Secondly, financial assistance to purchase its own shares could be abused by the directors of the company for their own benefit.

As per section 70(2), a company may give financial assistance for the purpose of or in connection with the acquisition of its own shares, if the board has previously resolved that

- (a) Giving such assistance is in the interest of the company;
- (b) The terms and conditions on which the assistance is given are fair and reasonable to the company and to any shareholders not receiving that assistance; and
- (c) Immediately after giving the assistance, the company will satisfy the solvency test.

Transactions not prohibited by section 70

- (a) if the assistance is given in good faith in the interest of the company.
- (b) where the ordinary business of the company includes the lending of money and if the lending is made in the ordinary course of business,
- (c) the provision by a company in good faith in the interest of the company, of financial assistance for the purposes of **an employees' share scheme;**
- (d) the granting of **loans** by a company to its employees other than directors in good faith in the interest of the company, with a view to enabling those persons to acquire beneficial ownership of shares in the company.

MINORITY BUY-OUT RIGHTS (SECTION - 93)

If a company has passed a special resolution or a written resolution regarding

- a) the **alteration of articles** which imposes or removes a restriction on the **business** or activities in which the company may engage
- b) a major transaction or
- c) amalgamation

A shareholder who voted against such special resolution or a shareholder who did not sign such a written resolution will be entitled to require the company to purchase his shares.

As per section 97 a company to which a notice has been given to purchase the shares may apply to court for an order exempting it from the obligation to purchase such shares, if such an application is made, the court may make an order exempting the company from the obligation to purchase the shares.

PROSPECTUS

Companies raise their original share capital through a process of invitation, application and allotment. The invitation is made by the company to the public to purchase its shares by way of a document called PROSPECTUS. The prospectus will set out the **terms of issue** and the **advantages** that would arise from an **investment** in the company. If any person is interested, he will apply for the shares. If the company accepts his application, it will allot shares to that person and enter his name in the register of members.

Definition of Prospectus

A prospectus is defined by section 529 of the companies act. It states that “prospectus means any prospectus, notice, circular, **advertisement**, or other invitation, offering to the public for **subscription** to or purchase of any shares or debentures of a company”.

The section further states that **though** such a prospectus, notice, circular, **advertisement**, or other invitation **expressly provide** that ‘it is not a prospectus’, still it is a prospectus.

Only public companies can publish a prospectus, because a private company cannot make any invitation to the public to purchase its shares. Therefore, a private company should not issue a prospectus.

Contents of a Prospectus

Sec. 37 (1) provides that every prospectus issued by or on behalf of a company or by or on behalf of any person who is or has been engaged or interested in the formation of the company, shall contain

- the information specified in **Part I** of the Fourth Schedule and
- it should set out the reports specified in **Part II** of Fourth Schedule
 - (i) Auditors Report
 - (ii) Accountants’ report

Minimum Subscription

As per Sec.45 (1) no allotment shall be made of any share capital of a company offered to the public for subscription, unless the amount stated in the prospectus as the **minimum amount (minimum subscription)** has been paid to and received by the company.

Here minimum subscription means the **minimum amount** which in the opinion of the directors, must be raised by the issue of shares for the following purposes:—

- (i) the purchase price of any property
- (ii) **preliminary expenses** and any **commission** payable to any person in consideration of his agreeing to subscribe for any shares in the company

- (iii) the repayment of any moneys borrowed by the company in respect of any of the aforesaid matters ;
- (iv) working capital;

To avoid this risk companies make underwriting agreements.

Underwriting

An underwriting contract is one which is made between the company and an 'underwriter'. The main condition in the contract is that the underwriter should subscribe for (purchase) a specified number of shares or debentures, in case, all or an adequate number of them are not taken up by the public. The underwriter receives an underwriting commission as consideration.

REMEDY FOR UNTRUE STATEMENTS IN A PROSPECTUS

Meaning of Untrue Statement

Sec.44 provides that a statement included in a prospectus shall be **deemed** to be untrue, if it is misleading in the form and context in which it is included; and a statement shall be deemed to be included in a prospectus, if it is contained in or in any report or memorandum appearing on the face of, or by reference incorporated in, or issued with, such prospectus.

Under the companies act there are two types of remedies available to a **subscriber** who purchased shares or debentures in a company **on the faith** of an **untrue statement** in the prospectus.

1. Civil case-Compensation under section 41
2. Criminal case under section 42

Compensation under S 41 - Civil Liability for Untrue Statements

Where a prospectus invites persons to **subscribe for** shares in or debentures of a company, the **following persons shall be liable to pay** compensation **to all persons** who subscribe for any shares or debentures **on the faith of the prospectus**, for the loss or damage they may have sustained by reason of any untrue statement included in such prospectus, that is to say:—

- (a) every person who is a director of the company, at the time of the issue of the prospectus;

- (b) every person who has authorised himself to be named and is named in the prospectus as a director;
- (c) every person being a promoter of the company; and
- (d) every person who has authorised the issue of the prospectus

Debt Capital

Debt capital is money raised by a company by taking out a loan that must be repaid over a period of time with interest. Debt financing can be either short-term or long-term. Generally, when a company borrows money from a person, the company gives company assets as security for the repayment. In case the company fails to repay the loan the creditor can get the assets sold and recover his money.

Debentures

A debenture is a document issued by a company stating a specified sum would be repaid with payment of a fixed rate of interest till such repayment.

S.529 defines a debenture as “debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not”.

Debentures may be secured by a charge on the assets of the company. Such charge may be

- (i) a fixed or specific charge or
- (ii) a floating charge, or
- (iii) a combination of the two.

FIXED CHARGES

Fixed charge means specific charge. A fixed charge is a mortgage of ascertained and definite property, such as company's land, building, machinery etc. If a fixed charge is created on a property, such a property cannot be disposed of by the company free of the charge

Example:- X (Pvt) Ltd borrows Rs.2 million from Mr. John, on the security of a land that belongs to the company. The land is secured as a fixed charge. Suppose X (Pvt) Ltd sells the land to Mr. Kumara, then Mr. Kumara will be purchasing the land with the charge, that is if X (Pvt) Ltd does not repay the loan with the interest to Mr. John, Mr. John may recover the land from Mr. Kumara.

As per Sec.431 the fixed security shall have priority over the floating charge.

FLOATING CHARGES

It is a very wide charge and may extend to present and future assets of the company. The charge floats over the assets charged, entitling the company to deal with them or dispose of them freely in the ordinary course of business until crystallization. Crystallization means the conversion of the floating charge into a fixed charge.

Floating charge has three main characteristics

1. it is on a class of assets present and future
2. the assets within the class will change from time to time
3. the company has freedom to deal with the charged assets in the ordinary course of its business

As per Sec.430, the creation of a floating charge in respect of any property shall not affect the ability of the company to deal with that property in the normal course of business. But the sale or disposal of the property should take place in the normal course of the company's business.

REGISTRATION OF CHARGES WITH THE REGISTRAR SEC.102

If a company creates a charge it is the duty of the company to submit a copy of the instrument by which the charge is created to be delivered to the Registrar for registration.

If an instrument executed in Sri Lanka it should be registered within 21 working days of the date of execution of the instrument; and in the case of an instrument executed outside Sri Lanka, it should be registered within three months of the date of execution of the instrument.

As per Sec.103, unregistered charges are void.

Constructive Notice on Register of Charges

As per Sec.105(1), the Registrar shall keep with respect to each company, a register regarding all the charges requiring registration and the Registrar shall issue a certificate of the registration of any charge stating the amount secured by such charge.

As per Sec.105(3) registration of a charge constitutes a notice to all persons of the particulars of the charge entered on the register of charges.

Advantages of Debentures

- The board does not (usually) need the authority of a general meeting to issue debentures.
- As debentures carry no votes they do not dilute or affect the control of the company.
- Interest is chargeable against the profit before tax.
- Debentures may be cheaper to service than shares.

Disadvantages of Debentures

- Interest must be paid out of pretax profits, irrespective of the profits of the company. If necessary must be paid out of capital.
- Default in repayment may lead to liquidation if the debentures are secured.
- High gearing will affect the share price.
- If the debt is personally guaranteed, liability will extend to non-business assets

Priority

The priority of a charge depends on

- The type of charge and
- The registration

Therefore

- A fixed charge has priority over a floating charge
- Among equal charges –a charge created first has priority over subsequent charges
- A registered charge has priority over an unregistered charge

Rights of Shareholders and Debenture Holders

Rights of Shareholders

- Shareholders are the owners of the company.
- Shareholders are invited to attend the annual general meeting of the company and they have the right to vote.
- Shareholders are paid dividends on their holdings, when there are sufficient profits made by the company.
- They are entitled to unlimited dividend
- shares are not secured
- In case of the winding up of the company, shareholders' funds are refunded after every claim is settled. Share capital is not returned except in case of redeemable preference shares.

Rights of Debenture Holders

- debenture-holders are the creditors of the company
- they are paid interest on debentures held by them
- The interest on debentures is paid on pre-determined fixed rates.
- Debenture-holders are not invited for general meetings, unless any decision affecting their interest is taken,
- They have no right to vote.
- Debentures are however normally secured and will be repaid by the company. Debenture-holders have a priority of the refund of their loan prior to shareholders.



FORM 6
Notice of
ISSUE OF SHARES

(Section 51(4)(a))

Section 51(4)(a) of the Companies Act No. 7 of 2007

[If there is insufficient space on the form to supply the information required, attach a separate sheet containing the information set out in the prescribed format]

No of Company

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Company Name

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Set out in the table below are particulars of the issue of shares by the above company.

Date of issue	Number of Shares	Consideration or its value determined as Provided in Section 58(2)

[Attach particulars of shareholders with their full names, addresses, NIC Nos/Passport Nos* and also a copy of terms of issue, approved under section 51(2) if any (to be declared in terms of section 51(4(b))]

Stated Capital prior to this issue

(a)

The consideration for which or its value determined as provided in section 58(2) for which the shares were issued in this issue

(b)

Stated Capital following this issue (a+b=c)

(c)

Signature of Director / Secretary*

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Full Name of Director / Secretary*

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Date

--	--

Day

--	--

Month

--	--

Year

Email (Optional)

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Presented by:

--

Telephone:

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Note:

This notice should be given to the Registrar-General of Companies, within 20 working days of the issue of any shares

Differences between share capital and loan capital

Share capital

- Shareholder
 - Owner of the company
 - He receives dividends for his investment
 - Can attend general meetings and vote
 - Dividend is paid out of distributable profits of
-
- No fixed rate of dividends
 - No need to repay
 - Can't claim dividends as of a right unless dividend is declared

Loan Capital (debentures)

debenture holder
creditor of the company
interest for his investment
no voting rights
interest should be paid out

Profits and if no profit out of capital
there is a fixed rate
should be repaid
can claim interest as of a

DISTRIBUTION



Dividend

Redeeming
redeemable
shares

Repurchasing
/acquiring its own
shares

Giving financial
assistance to any
person to purchase
co's own shares