REVIEWING THE TRADITIONAL CONCEPTS THAT UNDERLIE THE WORKINGS OF CAPITAL RAISING

**By Peter Lee Siew Choong (Chairman of Working Group B)
and the CLRC Secretariat**

Background

It has been reported that the private corporation (the registered company) is the most remarkable institutional innovation of the past two centuries.[1]

One key reason as to why a registered company (hereinafter referred to as company) is the preferred business vehicle is the ability of the registered company to raise capital for its operational needs.

Further, the company's ability to raise capital at the appropriate time can also rescue the company from being wound up on the grounds of insolvency.

At the same time, it is to be appreciated that unregulated capital raising may result in abuse and can be against the interest of the existing shareholders of the company. An example of such an abuse is the possibility of stock watering.

In respect to a company limited by shares, whose members enjoy the benefits of limited liability, creditors' interests are protected by the proposition which states that a limited company cannot return it's paid up share capital to its shareholders otherwise than in the manner prescribed by the law. Any return of the company's paid up share capital otherwise shall be treated as an illegal reduction of the company's paid up capital.

The law in regards to capital raising must therefore balance all these conflicting interests in order to ensure its continued effectiveness.

Some of our laws that regulate capital raising are built on concepts that were developed in the early 20th Century.

This article, among other things, seeks to highlight to its readers

- Some of the global corporate law reform trends in capital raising and capital maintenance; and
- Reasons as to why fundamental concepts that underlie the workings of capital raising would have to be reviewed.

---

[1] Financial Times 30 January 2002.

A review of the corporate law reform program as implemented and proposed by some commonwealth countries have brought to light the need to review two fundamental concepts that underlie the workings of capital raising.

These concepts include:

- The need of a company limited by shares to state its authorised share capital in its memorandum; and
- The need for shares to have a par/nominal value attach to it.

It appears that commonwealth countries that have implemented a corporate law reform program including those that are proposing to do so have proposed reforms that are designed to dispense with the continued application of the above two concepts.

Reform trends in respect to the authorised share capital clause as set out in the company's memorandum.

Currently our Companies Act 1965 (hereinafter referred to as CA 1965) requires a company limited by shares to include in its memorandum a share capital clause[2]. This clause seeks to impose a ceiling on the number of shares that can be issued by a company. Any issue of shares in excess of this ceiling is void[3].

Commonwealth countries such as Australia and New Zealand that have already implemented a corporate law reform program have done away with this ceiling and its reason being to simplify the processes of capital rising by companies.

Would doing away with the capital clause be against the interest of stakeholders?

The intended purpose of including a share capital clause in the company's memorandum is that it was thought that by its inclusion, shareholders' and creditors' interest in a limited company would be protected.

The share capital clause in the memorandum seeks to protect shareholders' interest by purportedly preventing stock watering. This is because, as was noted above, any share issued by the company in excess of its share capital clause is

---

[2] Section 18 (1) (c) CA 1965.
[3] Bank of Hindustan, China & Japan v Alison (1871) LR 6 CP 222.

void. Hence, the share capital clause acts as a limitation on the powers of the directors to issue shares[4].

However it must be pointed out that commonwealth Company legislation includes provisions designed to deal with stock watering.

For instance, the Australian Corporations Act 2001 includes a statutory pre-emption provision that in essence provides that new issue of shares must first be offered to existing shareholders in proportion to the number of shares held by the existing shareholders in a company.[5] It must be pointed out that although the CA 1965 does not have a similar provision of its Australian counterpart, the accompanying Table A to the CA 1965 does include a provision of similar effect[6]. Further, the CA 1965 also provides that the prior approval of shareholders must be sought before company directors can issue any new shares: section 132 D.

It is unlikely that creditors rely on the company's share capital clause when deciding whether to lend money to the company or not. This is because the company's share capital clause is not an appropriate indicator of the company's ability to repay its debt as the company need not have issued all its shares at once and shares issued and allotted need not be fully paid up.

Typically commonwealth Company legislation that requires a share capital clause to be inserted in the company's memorandum also provides companies with the means to increase its authorised share capital.

For instance, the English Companies Act 1985 that among other things includes a provision of similar effect to that of our current section 18(1) (c)[7], enables a company to increase its authorised share capital[8]. The CA 1965 as with its English counterpart also has a provision of similar effect[9].

Hence, despite the prohibition against issuing shares in excess of the company's share capital clause, companies can in fact issue shares in excess of its authorised capital clause. However, to do so, a company must first observe the procedures set out by the legislation by increasing its authorised share capital first.

Thus, requiring a company to have a share capital clause and at the same time also providing that companies can increase its authorised share capital merely adds to the existing complexity of the Companies legislation.

[4] Unregulated issuance of shares by directors can result in abuse of power. One typical abuse is that shares may be issued to change the current distribution of voting power within a company as was reported in Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821.
[5] Section 254 C.
[6] Article 41 of Table A.
[7] Section 2(5) English Companies Act 1985.
[8] Section 121(2) (a) English Companies Act 1985.
[9] Section 62 (1) (a).

Therefore, it is not surprising to note why the UK Company Law Review Steering Group in its final report titled '*Modern Company Law for a Competitive Economy*' proposed among other things for the abolition of "authorised share capital" clause in the company's memorandum.

Par /Nominal Value of shares

The requirements that a company must state its authorised share capital in its constitution as discussed above and that shares must be issued with a par/nominal value are entrenched concepts of company law in the common law jurisdictions.

In Malaysia, both these concepts are reflected in our CA 1965 and are regarded to be general principles of Malaysian Company Law.

Yet as was noted above, various common law jurisdictions which had once observed these concepts as part of their respective company law have in fact done away with them or are in the process of recommending doing away with them.

In respect to the requirement that shares issued must have a par value new Company legislation or proposed reforms to existing Company legislation now provides that shares can be issued without par value. Such shares are referred to as NPV shares. NPV shares are issued for an issue price as opposed to at par value[10].

Recently, the Singapore Companies Legislation and Regulatory Framework Committee ('CLRFC') has proposed to amend its Companies Act Chapter 50 by recommending among other things, that its companies be allowed to issue only NPV shares.

It should be pointed out, that although the English have been cautious in recommending the introduction of NPV shares into English company law[11], there is now a change in the mind set in respect to this proposal.

The UK Company Law Review Steering Group in its final report titled '*Modern Company Law For A Competitive Economy*' had among other things, proposed for the introduction of NPV shares. However, because of the constraint imposed by the *EU Second Company Law Directive*, the UK Company Law Review

[10] South Africa, New Zealand and Australia can be citied as examples.
[11] As reflected by the *Gedge Committee* Report (1954) and the *Jenkins Committee* Report (1962).

Steering Group did not take the further step of introducing NPV shares into English company law.

Despite this, it must be pointed out that the UK Company Law Review Steering Group in its report strongly supported the introduction of NPV shares as verified by the following statement:

But we believe that the abolition of par value shares for all companies should be a long-term objective, and we recommend that the Secretary of State's power should enable him to achieve this without the need for primary legislation if and when the EU constraint is removed.[12]

Arguments for and against the introduction of NPV shares

The table below sets out a summary of the arguments for and against the introduction of NPV shares.[13]

Arguments in favour of abolishment PV	**Arguments against the abolishment PV**
Nominal value is misleading. It obscures the reality that a share is no more than a proportionate interest in the net worth of a business	Nominal value is not misleading. Business people are not generally misled in assessing the value of shares by the existence of nominal value
The existence of a nominal value of a share different from its market value can cause confusion for individuals who are newcomers to investment in shares. A stated nominal value can be misleading to creditors as well as shareholders.	
Nominal value can add to the complexity of a company's financial statements. If there were no requirement of a nominal value, there	

[12] Page 219 para 10.7 of the Final Report.

[13] These arguments were sourced from various reports and papers prepared by other common law jurisdictions. They include the Australian Companies and Securities Law Review Committee Discussion Paper 10 tiled 'Share of no par value and Partly paid shares, the New Zealand Law Commission Report No 9 titled 'Company Law Reform and Restatement' and the Final Report prepared by the UK Company Law Review Steering Group.

would be no need for the concept of a share premium account.	
Nominal value can lead to complexity in a company's share capital structure. It is an established principle of law that a limited company is not free to issue shares at a discount to its nominal value. A limited company whose shares have a market value below their nominal value can only issue shares at a discount provided the company first observes the complex procedures as set out in the Companies legislation.[14] A common feature of these procedures includes among other things, the need to make an application to the Court which involves expenses and delay and there is also a scope for misunderstanding. In practice a company may not wish to be seen to be forced to issue its shares at a discount. It may prefer to create a new class of shares. In the event the requirement of nominal value is done away with and the company can issue NPV shares, the company would be able without any application to the Court to issue shares of the same class at their market price. True, a well-informed market would realise that the new issue is on more advantageous term than the original issue, but it would be only the market price that is relevant.	Difficulties about issue of shares at a discount can be removed without abolishing nominal value. The prohibition against issuing shares at a discount without the court's approval can be overcome in other ways. One way would be to enact provisions allowing for the issue of shares at a discount provided it has been approved by the shareholders and giving creditors an opportunity to object.

[14] In Malaysia shares can be issued at a discount but provided prior to that issue the company observes the procedures set out in s 59 CA 1965.

The current practise of offering shares to the public at different prices has made the question of the par value of shares of the company immaterial. As was the case with the bigger initial public offerings these shares were offered and sold at varying prices to different sets of investors. The emphasis was and will continue to be the offer price and not the par value of the shares in question.	
Creditors do not rely on nominal value for protection. Creditors of limited companies are influenced more by the company's business reputation, its net worth and its cash flow than by the amount contributed by its shareholders or the amount of their statutory liability to contribute. In many cases, the capital raised by the allotment of shares has little relationship to the resources employed by the company. A company with an issued capital of $2 may be quite sound in terms of net worth or cash flow. If a limited company were to have shares of no par/nominal value, creditors could still have the benefit of the principle that contributions of capital are not to be returned to members before liquidation except in an approved reduction of capital or a permitted buy-back. This principle can be implemented by among other things, requiring that the	

consideration received by a company for the allotment of its shares be carried to a contributed capital account and restricting the distribution of the amount in that account. Further, prohibitions can also be imposed on a company to restrict its ability to release its shareholders from liability to pay any outstanding amount of the issue price.	
Nominal value does not wholly prevent stock-watering. The fundamental problem is one of ensuring that directors do not allot shares except for adequate consideration.	
Par value has given rise to unproductive complexity in accounting and substantial formality in management.	

Perhaps the strongest criticism against shares having a par value was that articulated by the *New Zealand Law Commission Report no 9* 'Company Law Reform and Restatement'.

The New Zealand Law Commission said:

We have concluded that no useful function is served by the par value concept. Moreover, it is arbitrary and misleading. Its abolishment would mean that financial accounts can be greatly simplified (share premium accounts and "reserves" are concepts that will no longer be required)[15].

Conclusion

[15] At p 93 para 381 of its report.

The CLRC, established by the Companies Commission Malaysia has been given the gargantuan task of reviewing the Companies Act 1965.

In carrying out its function, the CLRC will have to review traditional concepts that underlie the workings of the Act and if the CLRC is of the view that its continued preservation is not in the best interest of current corporate law, the continued application of rules that reflect these traditional concepts ought to be abolished so as to ensure that our corporate law remains contemporary and can enable our companies to compete within the global scene and spur entrepreneurship within our nation.