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SHARE REPURCHASE – SOME POLICY AND LEGAL ISSUES

The Companies (Amendment) Act 38/1998, passed on 12 October 1998, introduced new provisions permitting companies to buy-back their shares. The Inland Revenue Authority of Singapore and the Securities Industry Council subsequently issued directions and policy statements relating to share buy-backs. This article examines some of the policy and legal issues arising from the rules governing share buy-backs. Amongst these are: the concept of 'ordinary shares', whether the safeguards under the different methods of share buy-backs adequately protect the interests of the shareholders, the tax treatment of proceeds received in a share buy-back and the implications for directors' duties. The new Practice Note 13 to the Singapore Code on Take-overs and Mergers will also be examined briefly.

1. *Overview*

ON 12 October 1998, Parliament passed the Companies (Amendment) Act 38/1998. One of the significant changes made by the Act is the allowance for a company to make share repurchases under prescribed conditions. Whereas a company was previously prohibited from buying back its own shares, the new provisions permit a share buy-back to be carried out by one of three methods:

(1) Off market acquisition on an equal access scheme[1]

(2) Off market acquisition on a selective basis[2]

(3) Market acquisition[3]

A public listed company may adopt methods (1) or (3) but not method (2).[4] In other words, a public listed company is not permitted to buy back

[1] S 76C Companies Act (Cap 50) (as amended by Companies (Amendment) Act 38/1998) (hereinafter "CA").

[2] S 76D CA.

[3] S 76E CA.

[4] S 76D(1)(d) CA.

its shares from a select group of shareholders. It has either to offer to buy from all shareholders a fixed percentage of their shares, or to make purchases of the shares on the stock exchange.

An unlisted company may adopt methods (1) or (2); it goes without saying that method (3) is unavailable by reason of its shares not being traded on a stock exchange. An unlisted company thus has the additional capability to contract with only some of its shareholders for the buy-back of their shares. A selective share buy-back presents the danger that the company may offer to selected shareholders especially favourable terms which are not available to the other shareholders. This danger, as we shall see, is mitigated somewhat by taking away from the interested shareholders the power to vote on a resolution which potentially benefits them.

This article seeks to highlight some of the legal and policy issues associated with share buy-backs in Singapore. In Section 2, I suggest that the limitation of share buy-backs to 'ordinary shares' causes some uncertainty insofar as the term though seemingly clear can be used on different classes of shares. In Sections 3 to 5, I survey the various permitted methods of share buy-backs and suggest some refinements to better safeguard the interests of the remaining shareholders. In Sections 6 and 7, I examine the tax treatment of share buy-backs and the implications for corporate finance planning as well as directors' duties. As a share buy-back decreases the number of outstanding shares of a company, the remaining shareholders will increase their voting power in the company; section 8 summarizes the position taken by the Securities Industry Council on this aspect in Practice Note 13 to the Singapore Code on Take-overs and Mergers.

A number of conditions apply to all three forms of share buy-back. It would be appropriate to set out some of them for they affect the context and manner in which the three forms of share buy-backs operate. Amongst the conditions to be found in the new provisions of the Companies Act are:

(i) only ordinary shares may be repurchased;[5]

(ii) the articles of a company must expressly permit a share buy-back;[6]

[5] S 76B(1) CA.

[6] *Ibid.*

(iii) the total number of shares repurchased by the company in the statutorily prescribed period (known as "the relevant period")[7] must not exceed 10% of the issued ordinary share capital.[8] (This may be termed the "10% rule");

(iv) repurchased shares are deemed cancelled immediately upon repurchase;[9]

(v) directors are required to lodge with the Registrar a notice in the prescribed form within 30 days of a share repurchase;[10]

(vi) the company may only make payment for share buy-backs out of distributable profits.[11]

For companies listed on the Stock Exchange of Singapore (SES), clause 948(3) of the SES Listing Manual requires the provision of the following information in addition to the information mandated under the Companies Act:

(i) reasons for the proposed share buy-back;[12]

(ii) whether any consequences follow by reason of the Singapore Code on Take-overs and Mergers;[13]

(iii) whether there is any effect on the continued listing of the security on the SES;[14] and

(iv) information pertaining to previous share buy-backs.[15]

2. *The trouble with 'ordinary'*

Only ordinary shares may be repurchased.[16] What, however, are ordinary shares? The phrase is not defined in the Amendment Act. At common law,

[7] See s 76B(4) CA for definition of 'relevant period'.

[8] S 76B(3) CA.

[9] S 76B(5) CA.

[10] S 76B(9) CA.

[11] S 76F(1) CA. "Distributable profits" is defined in s 76F(4) to mean "profits that are available for payment as dividends but excludes any amount in ... (i) the share premium account ... and (ii) the capital redemption reserve ..."

[12] Cl 948(3)(b) SES Listing Manual.

[13] Cl 948(3)(c) SES Listing Manual.

[14] Cl 948(3)(d) SES Listing Manual.

[15] Cl 948(3)(e) SES Listing Manual.

[16] S 76B(1) CA.

'ordinary shares' is frequently used in contra-distinction to 'preference shares'. If this is indeed the intention of the draughtsman, it would have made for greater consistency to adopt instead the term 'equity share' since this is defined by the Act to mean 'any share which is not a preference share'.[17] The drafting could perhaps have been done in a more felicitous manner.

More importantly, the adoption of the term 'ordinary shares' without there being a precise statutory definition can present some obstacles to corporate planning. Gower describes ordinary shares as 'the residuary class in which is vested everything after the special rights of preference classes, if any, have been satisfied'.[18] If indeed by an ordinary share is meant a share other than a preference share, one has to inquire what exactly is a preference share. The Companies Act defines 'preference share' only for the purposes of sections 5, 64 and 180;[19] it is therefore not helpful for the present purposes. *Gore-Browne on Companies* takes a preference share to mean a share which has a preferential right: "(1) as to dividend only; (2) as to return of capital only, or (3) both as to dividend and to return of capital."[20] Hence, a preference share may be understood to mean a share that has a prior claim on the earnings available for distribution as dividends, and/or a prior claim to the return of capital. If this be the proper understanding of what a preference share is, it would mean that a class of shares which has *either* preferential rights as to dividends *or* preferential rights as to return of capital cannot be repurchased. A narrower view of preference share is taken by Pennington who sees the defining characteristic of a preference share as the prior claim on the earnings available for distribution as dividends.[21] The position is supportable by the dictum of Lopes LJ in *Re Brighton & Dyke Ry:*

> What I understand to be the definition of a preference share is this – a right conferred upon the holder to receive interest in priority to the ordinary shareholders.[22]

[17] S 4(1) CA.

[18] L C B Gower, Principles of Modern Company Law (5th ed, 1992).

[19] S 4(1) CA ("[A] share by whatever name called, which does not entitle the holder thereof to the right to vote at a general meeting ... or to any right to participate beyond a specified amount in any distribution whether by way of dividend, or on redemption, in a winding up, or otherwise.")

[20] Supplement 27 section 14.4. This is also the view taken in *Halsbury's Laws of England* (4th ed) vol 7(1) (reissue) para 176.

[21] Pennington, *Company Law* (6th ed, 1990) p 206.

[22] (1890) 44 Ch D 28 at 38.

Quare: whether Lope LJ meant to provide an exhaustive common law definition of 'preference share'? Adopting the narrower concept of preference share would mean that a class of shares which only confers a prior right to the return of capital without a right to preferential dividend may be repurchased under section 76C, section 76D and section 76E.

A share may carry with it a prior right to a fixed dividend and a right of participation in the residual income or residual capital. Such a share may be termed a 'preference share'. It may also be termed a 'preferred ordinary share'.[23] Such a share carries both the characteristics of a preference share (prior right to dividend or capital pool) and an ordinary share (participation in a residual pool available for distribution as dividend or return of capital). This is where a definition with 'bright lines' (as it were) would be really helpful. Does the mere existence of a preferential right take the share out of the category of ordinary shares? Or should one consider all the characteristics of the share and then determine whether it is more in the nature of an ordinary share or more in the nature of a preference share? In this regard, it is important to remember that it is possible to create different classes of ordinary shares with differing rights; each Class A share may be entitled to twice the dividends that is to be distributed to a Class B share. Alternatively, each class of shares may have different voting rights;[24] Class A shares may have four votes each while each Class B and Class C share may only have one and two votes respectively.

The absence of a clear definition creates unwelcome uncertainty for the corporate adviser. This has an knock-on effect for corporate finance planning. Share buy-back offers an exit option for a financier. His desire for certain preferred rights may mean that the power to repurchase under the new provisions is unavailable for use. Rather than risk the uncertainty associated with whether the contemplated shares constitute ordinary shares, the corporate adviser would prefer to find structures which are not beset with the same uncertainty. He may structure the transaction as an issue of redeemable preference shares under section 70 Companies Act. This however carries the limitation, *inter alia,* that the shares may only be redeemed 'on such terms and in such manner *as is provided by the articles'*. A change in the business conditions necessitating a variation of the terms set down in articles would require a change to the articles. In contrast, the new provisions allowing for share repurchase require only an ordinary or a special resolution (as the case may be) – a change to the articles is not necessary.

[23] Gower, *Principles of Modern Company Law* (5th ed, 1992) p 374.

[24] This is only possible in a private company as ss 64(1) and 64(5) CA together require that each equity share in a public company must carry only one vote.

3. *Selective Off-market Acquisition*

A selective off-market acquisition may be carried out by an unlisted company under the conditions set out in section 76D. The proposed agreement for the selective off-market purchase must be authorised by the company at a general meeting;[25] it must also have been available for inspection before the meeting and at the meeting itself.[26] Authorisation for a selective off-market acquisition requires a special resolution of the company.[27] Persons whose shares are proposed to be purchased (what may be termed "interested persons"), together with their associated persons, are not to vote on the resolution.[28] Section 76D(2) says:

> The terms of the agreement for a selective off-market purchase must be authorised by a special resolution of the company, with no votes being cast by any person whose shares are proposed to be purchased or acquired by his associated persons ...

"Associated persons" is defined in section 76D(14) to mean:

(a) the person's spouse, child or step-child; or

(b) a person who would, by virtue of section 7(5), be treated as an associate of the first-mentioned person.

The kinds of relationships caught by section 76D(14)(b) are quite wide-ranging. The following would be associated persons of an interested person:

1. a holding company of the interested company;[29]
2. a subsidiary company of the interested company;[30]
3. a company which shares the same holding company as the interested company;[31]

[25] S 76D(1)(a) and s 76D(2) CA.

[26] S 76D(7) CA.

[27] S 76D(2) CA.

[28] S 76D(2) CA. Interested persons and associated persons are not permitted to vote whether in a poll or otherwise: s 76D(6)(a). The same voting restrictions apply when the company seeks to release its rights under a selective share buy-back agreement: s 76D(12) CA. Notwithstanding anything in the company's articles, any member may demand a poll: s 76D(6)(b) CA.

[29] S 7(5) CA read with s 6.

[30] *Ibid.*

[31] *Ibid.*

4. a person[32] in accordance with whose wishes the interested person is accustomed, or is under an obligation (whether formal or informal) to act;[33]

5. a person[34] who is accustomed, or is under an obligation (whether formal or informal) to act in accordance with the wishes of the interested person in relation to the shares.[35]

(i) *Non-compliance with voting restriction*

An issue which may arise is: what is the effect of non-compliance with the voting restriction? The statutory provisions do not state expressly – as section 76D(7) does the consequences for the non-compliance with the requirement to make available for inspection the buy-back agreement – that the special resolution is ineffective if the condition is breached. *Re R W Peak (Kings Lynn) Ltd*, interpreting the UK equivalent of section 76D,[36] offers some guidance on the effect of non-compliance with the conditions laid down in section 76D.

In *Re R W Peak (Kings Lynn) Ltd,*[37] the company repurchased the shares of the majority shareholder without an amendment to the articles to allow for share repurchase. This case involved a selective off-market repurchase which required authorisation by a special resolution of the company; there was no special resolution authorising the repurchase contract before it was entered into. Further the contract was not made available for inspection under the equivalent of section 76D(7).[38] The issue was whether the sale transaction was void. The company sought to argue, relying on *Re Duomatic Ltd*,[39] that the formalities set out in the statute need not be strictly complied with where all the shareholders had unanimously consented. Lindsay J rejected the argument. Lindsay J held that the statutory conditions must be strictly complied with and held that the sale was void. Although there

[32] Where the interested person is accustomed or is under an obligation (whether formal or informal) to act according to the wishes of a body corporate or its directors, the body corporate would also be an associate: s 7(5)(e) CA.

[33] S 7(5)(b) CA.

[34] A body corporate whose directors are accustomed or are under an obligation (whether formal or informal) to act in accordance with the wishes of the interested person would also be an associate: s 7(5)(d) CA.

[35] S 7(5)(c) CA.

[36] S 164(6) Companies Act 1985 (UK).

[37] [1998] 1 BCLC 193.

[38] S 164(6) Companies Act 1985 (UK).

[39] [1969] 1 All ER 161.

are some points of distinction between the UK Act and the Singapore Act,[40] the main basis on which Lindsay J proceeded is instructive. By statute, Parliament has laid down a general rule prohibiting a company from acquiring its own shares.[41] It also lays down the anciliary general rule that an acquisition in contravention of the earlier general rule is void.[42] Under the Singapore Companies Act, the prohibition does not extend to:

> the purchase or acquisition or proposed purchase or acquisition by a company of its own shares in accordance with section 76B to 76G.[43]

A transaction that does not comply with the formalities prescribed by the enabling sections falls outside the 'safe harbour' afforded by these sections. It falls to be governed by the general prohibition. Ergo, the transaction is void.

If *Re R W Peak (Kings Lynn) Ltd* is to be followed in Singapore, non-compliance with the voting restriction will invalidate the authority and render the repurchase contract void – the contract will be an unauthorized buy-back by a company of its own shares and would amount to a contract to perform an illegal act.

(ii) *Displacement of rule in North-West Transportation* v *Beatty*[44]

The voting restriction is a displacement of the rule in *North-West Transportation* v *Beatty* that the majority is not disqualified from voting notwithstanding their interest in a transaction. It makes for good policy to suspend the voting rights of interested parties. It removes the risk that the interested parties may exercise their votes to appropriate to themselves the resources and assets of the company at the expense of the other shareholders. If an interested party is voting to divest himself of his interest in a company, he has little interest in preserving the value of the company, much less in enhancing it. To the contrary, he has every incentive to extract the maximum out of the company without regard to the effect of the buy-back on the company. There is therefore every danger that he would exercise his votes at variance with the interest of the remaining shareholders (*ie*,

[40] See Pt I and Pt II of Schedule 15A to (UK) Companies Act 1985 especially para 5 which find no equivalent in Singapore.

[41] UK: s 143(1) Companies Act 1985. Singapore: s 76(1)(a) CA.

[42] UK: s 143(2) Companies Act 1985. Singapore: s 76A(1)(a) CA.

[43] S 76(9)(c) CA (added by the Companies (Amendment) Act 1998). The UK equivalent is s 143(3) Companies Act 1985:

> [The general prohibition found in s 143(1)] does not apply to – (a) the redemption or purchase of shares in accordance with Chapter VII of this Part.

[44] (1887) 12 App Cas 589.

to maximize the value of the company). The position in *North-West Transportation* v *Beatty* is sustainable insofar as the rule is premised on the notion that the majority would, by reason of their stake in the company, act to preserve or enhance the value of the company. In such circumstances, it is defensible to permit corporate actions to be decided by the interested majority notwithstanding their interest in the transaction. The same does not obtain in the 'end-game' scenario for a shareholder who is about to exit the company at a price that he is able to set for himself. It is therefore eminently correct to suspend the voting rights of those who stand to benefit from the share buy-back. By requiring a special resolution to be passed by shareholders not entitled to the benefit of a selective share buy-back, the rule gives to whose would continue to hold an interest in the company the prerogative to decide whether it is in their collective interest to permit the proposed share buy-back.

(iii) *A need for further disclosure regarding impact of share buy-back on value of shares*

The voting restriction, however, goes only part of the way toward ensuring that the shareholders who would continue to hold an interest in the company are not taken advantage of. To enable the shareholders to exercise their judgment on the question of whether it is in their interest and that of the company to authorise the selective share buy-back, there would need to be explained to these shareholders reasons for the proposed share buy-back. It is undoubtedly true that in many cases, the proponents of a share buy-back would state their reasons in order to persuade the other shareholders to authorise the proposed buy-back. If one were to pay regard to the principle in finance theory that directors should aim to enhance shareholder value, the impact of a buy-back on shareholder value should be one of the principal considerations of the directors. Shareholders invest in a business corporation to maximise their returns. They have an interest in the impact of a buy-back on the value of their investments.

Section 76D(3)(b) requires the notice specifying the intention to propose a special resolution to authorise an agreement for a selective repurchase to:

> specify the source of funds to be used for the purchase or acquisition *including the amount of financing and its impact on the company's financial position.*

The concern addressed here is the effect of the buy-back on the solvency of the company. It addresses the concerns of creditors (solvency), not so much the concerns of the remaining shareholders (shareholder value).

While there may be many legitimate reasons for carrying out a share buy-back, the core concern to the remaining shareholders – impact on shareholder value – should be made an item of mandatory disclosure. The current discretion given to directors to decide how to "sell" the buy-back proposal permits obfuscation of one of the central concerns in a corporate transaction of this nature.[45] Directors have the leeway to focus on an advantage of the buy-back while brushing over the impact on the value of the remaining shares. It is suggested that this item which lies at the very heart of corporate finance theory is too important to be left to directors to decide whether and how to address the question. It is suggested that the directors should be made to state the likely impact of the share buy-back on the value of the remaining shares. Further, they should also be made to state the basis of their assessment. The obligation is not an onerous one. The valuation exercise is an evaluative one. There is room for a margin of error. The most important aspect of requiring mandatory disclosure of the suggested items is the disclosure of an item of information closest to the heart of a shareholder so as to equip him to vote in accordance with his interest. It gives to the voting shareholders an important basis by which to make an informed choice.

Such a mandatory disclosure prevents the stealing away of value from remaining shareholders to fulfil some other agenda. The directors are made to address head-on the 'cost' of pursuing an aim other than the enhancement of shareholder value. Shareholders are thus empowered to decide whether the proposed aim is worth the cost. If the directors or a powerful shareholder wishes to rid of a particularly irksome faction through a buy-back, there is in place a mechanism that informs the other shareholders who take no part in the dispute the cost they are made to bear. Without mandatory disclosure, the proponents are in a position to make the unsuspecting shareholders bear a cost without adequate disclosure.

A legal regime that promotes good corporate governance should not only make available to aggrieved minority shareholders legal redress for minority oppression. It should also build an environment that is conducive to the safeguarding of minority interests. To require an assessment of the impact of the buy-back on share value to be included would not only enhance transparency and promote the directors' accountability to shareholders. It would also enhance the safeguarding of minority interests.

[45] Note should be made of cl 948(3)(b) of the SES Listing Manual; listed companies are required to give the reasons for a proposed share buy-back. As only unlisted companies are entitled to engage in selective share buy-backs, the clause does not apply to them. Even if it does, the clause does not go far enough to address the specific concern raised above.

4. *Off market acquisition on an equal access scheme: ex facie equal access or substantive equal access?*

All companies, whether listed or unlisted, can make share repurchases on an off-market equal access scheme provided the scheme has received the prior authorisation by the company at a general meeting. The statutory provisions do not specify the kind of resolution that is necessary to grant the authority for such a scheme; as such, an ordinary resolution will suffice unless the articles of the company provide otherwise.

To qualify as an "equal access scheme" under section 76C, section 76C(6) specifies that the scheme must satisfy all of the following conditions:

> (a) the offers ... are to be made to every person who holds shares to purchase or acquire the same percentage of their shares;
>
> (b) all of those persons have a reasonable opportunity to accept the offers made to them;
>
> (c) the terms of all the offers are the same except that there shall be disregarded –
>
> (i) differences in consideration attributable to the fact that the offers relate to shares with different accrued dividend entitlements;
>
> (ii) differences in consideration attributable to the fact that the offers relate to shares with different amounts remaining unpaid; and
>
> (iii) differences in the offers introduced solely to ensure that each member is left with a whole number of shares."

The strict conditions which govern what amounts to an equal access scheme aim, as its name suggests, at the equality of treatment for all shareholders. The condition relating to an offer for an identical percentage of all members' shareholdings and the requirement regarding similarity of terms attempt to ensure that no shareholder is better treated than others. They are important and especially useful in the context of an unlisted company for they aid in assuring all members that they are offered a *pro rata* payout of the company's assets.

In the context of a listed company, however, the "equality conditions" do not necessarily present all shareholders equality of opportunity to receive a *pro rata* payout of the company's assets. The normal trade of shares listed on the Stock Exchange of Singapore is in lots of 1,000 shares. Small investors holding just a few lots of shares may find that they will be left with odd number of shares after a repurchase. Take the case of an investor who holds 2,000 shares in a listed company. The company offers to all shareholders a buy-back of 10% of all their shares. If the investor accepts the offer, he will be left with 1,800 shares. The case of an investor who already holds odd lots (due to bonus issues or otherwise) is made more unenviable. Under the above 10% buy-back scheme, a holder of 2,200 shares will be left with 1,980 shares. The discounts suffered when trading in odd lots, together with the inconvenience and other difficulties associated with trading in odd lots, is likely to cause small investors to decline the offers. The "equality conditions" do not go far enough to address the predicament that confronts small investors. The "equality conditions", while assuring that a scheme would appear on paper to grant equal access, do not sufficiently assure practical equal access.

A company which desires to spare small investors the inconvenience of holding odd lots may only offer such shareholders the option of tendering a lower number of shares; it cannot offer to buy the number equivalent to the next nearest rounded up number of lots. This is in the case of a company which *bona fide* wishes to benefit its small investors.

There is a serious lacuna in the present provisions – the present provisions permit a company the leeway to favour large shareholders. More objectionably, this is done at the expense of small investors. An illustration helps demonstrate the point.

Acme Co has a market capitalisation of $80,000,000. Its ordinary shares number 40 million. Its shares are trading at $2.00 each. The largest shareholder, L, holds 16 million shares in the company (40%); the market value of his shares is thus $32,000,000. The company can plan what is in effect a selective buy-back by offering to repurchase only 1% from all shareholders at 10% premium on the market value. That is, the company offers to repurchase shares at $2.20 a piece. Shareholders who hold just a few lots will in all likelihood decline the offer. If one holds 5,000 shares, one will by accepting the offer be able to tender only 50 shares; the premium one stands to gain is only $10 (50 x $0.20). To obtain this benefit, he suffers the inconvenience of holding 4950 shares (5, 000 less 50). This is hardly worth his trouble. The situation of L, however, is different. He is able to tender 160,000 shares. For this he obtains $352,000 whereas he would only be able to obtain $320,000 on the market. The additional advantage to him is $32,000.[46] The collective loss to all the other shareholders is $352,000 – the company loses $352,000 in assets by what is *ex facie* an equal access scheme but that is effectively a selective buy-back.

[46] See also the advantage of an increased base cost: main text, section 6.

It is suggested that the 'equality conditions' should be fine-tuned to safeguard the interests of small investors on the market. This can be done very easily by a qualification to the rule that the company can only offer to repurchase a fixed percentage from each shareholder. In the case of a listed company, the rule should be subject to an overriding condition that where the fixed percentage set by the company results in an offer to purchase an odd number of shares, the offer shall be deemed to be an offer to purchase the number of shares representing the next nearest rounded up number of lots. (This may be termed the "rounding-up rule"). So if the fixed percentage results in an offer to purchase 430 shares, the offer shall be deemed to be for 1,000 shares (next nearest rounded up number of lots). Such a deeming provision would ensure that small investors will not face the prospect of odd lots after a repurchase.[47] At the same time, it would safeguard against the moving of value away from small investors to the owners or large investors, *ie,* a selective buy-back under the guise of an equal access scheme.

One effect of the deeming provision is that an overwhelming response from shareholders might result in shares amounting to more than that allowed under the 10% rule being tendered. This can be easily avoided by a corollary rule providing that the company is to conduct a ballot in the event that it receives acceptances amounting to more than that which it is permitted to repurchase under the 10% rule. The names of the members accepting the offer are mixed to form a random list. The members whose names fall higher up on the list get their shares repurchased. The cumulative number of shares is computed as one goes down the list. The member whose tender causes the company to cross the 10% threshold would be rejected; the next member whose tender would not cause the company to cross the 10% threshold is selected. The process is repeated until the purchase of the next single lot of shares would cause the company to cross the 10% threshold.

A company may desire to repurchase a lesser percentage of shares. In order that the company may achieve its desired outcome and not be obliged to repurchase more than the percentage stipulated, the company should be given the power to ballot for shares up to the level set out in its offer document. This would enable a listed company to achieve its objective. At the same time, small investors are assured that they would not be taken advantage of.

The equality conditions go a long way toward assuring fairness to all shareholders. The additional rules suggested would further improve on this aim in the context of listed companies.

[47] *Ie*, they did not have odd lots to begin with.

5. *Market Acquisition*

A company listed on a stock exchange may acquire its shares on the stock exchange provided the acquisition has received the prior authorisation of the company at a general meeting.[48] For the purpose of equipping shareholders with the necessary information by which to evaluate the resolution sought to be passed, section 76E(2) requires the notice specifying the intention to propose the resolution to state a number of items of information. These are: (a) the maximum number or percentage of shares the company is permitted to purchase; (b) the maximum price that may be paid for the shares; (c) the date on which the authority is to expire; (d) the source of funds, the amount of financing, and its impact on the company's financial position. These are also the parameters to be set out in the resolution.[49] For companies listed on the SES, clause 948(3) of the SES Listing Manual requires the disclosure of other relevant items of information to help shareholders evaluate the proposal.[50]

The procedure for obtaining authority to make a market acquisition is not riddled with conditions and rules similar to that required for a selective off-market share buy-back. Whereas a selective off-market share buy-back poses the very real risk of a particular shareholder obtaining an especially favourable deal to the exclusion of others, an on-market transaction stands on a different footing. The price at which a transaction may be made is at or near market prices – the SES Listing Manual clause 948(4) lays down a dealing restriction on a company to the effect that the price that the company may pay for the shares is not to be more than 5% above the average closing market price of the shares over the last 5 market days.[51] In the ordinary course of trading through the Exchange's Central Limit Order Book ("CLOB") trading system, it is difficult to prefer selected shareholders and buy shares from them at an especially attractive price. The queuing system matches a potential buyer to the lowest asking rate. Unless the shareholder's asking rate for the shares becomes the lowest, the buying company cannot select him. The company can make a bid exceeding the current highest bid rate; the shareholder's broker must be quick enough to 'catch' it before others.

[48] S 76E(1) CA.

[49] S 76E(3) CA.

[50] See text to notes 12-15.

[51] See also Minister of Finance Dr Richard Hu's statement in *The Straits Times* 13 October 1998 p 12.

The manner in which the shares are transacted on the SES limits the potential for a selective sale to particular shareholders.[52]

6. *Off-market transaction or on-market transaction? The tax dimension*

From the perspective of corporate finance planning, the tax treatment of share buy-backs is, without doubt, one of the most important considerations. In planning a share buy-back scheme, a company has invariably to put itself into the shoes of the shareholder to see whether it is in the shareholder's best interest to engage in the proposed share buy-back. The tax treatment shapes and determines the cash-flow to both the company as well as the shareholder who is counterparty to the buy-back transaction. It plays a pivotal role in determining whether a share buy-back is financially attractive and likely to be accepted by a shareholder. The imputation system adopted in Singapore, together with the position taken by the Inland Revenue Authority of Singapore with regard to share buy-backs, enhances the financial attractions of certain share buy-backs to the shareholders.

[52] Married deals present a couple of interesting issues. If the married deal is done through the by-pass system that permits the selection of the counterparty, it is questionable whether it falls within the definition of 'a purchase ... on a stock exchange' (s 76E(1) CA). The latter phrase may be interpreted, consistent with the stance taken by the SES in cl 948(2), to mean "a purchase transacted through the Exchange's Central Limit Order Book ("CLOB") trading system". A married deal carried out in such a manner should be interpreted not to fall within the ambit of an approved on-market purchase in s 76E CA.

It is possible to do what is called a 'contango' at the start of the trading day; when the market opens, the bid or ask rate is entered with the counterparty ready to "snatch" it up immediately. Such an arrangement is an on-market purchase. The directors who approve such a married deal would probably be in breach of their fiduciary duty toward the company insofar as they permit the depletion of corporate resources beyond what the free market would extract. See also Tan Cheng Han, "Reflections on the Companies (Amendment) Bill No 36/98" (1998) 10 SAcLJ 287 at 293.

The participation in a married deal may also amount to a breach of s 97(1) of the Securities Industry Act ("False trading and market rigging transactions"). See particularly, s 97(3)(c) (A person is deemed to have created a false or misleading appearance of active trading in securities on a securities exchange if he "makes ... an offer to purchase any securities at a specified price where he ... knows that a person associated with him has made... or propose to make ... an offer to sell the same number, or substantially the same number, of securities at a price that is substantially the same as the first mentioned price"). The presumption in s 97(3)(c) may be rebutted: s 97(4).

The detection of especially favourable married deals is easy for companies listed on the SES; cl 948(6)(a) of the SES Listing Manual requires the listed issuer to notify the Exchange, "not later than 9.00 am on the market day following the day on which it has purchased shares", of the purchases in the set format. The reporting requirement found in s 76B(9) CA is less exacting – the directors are required to lodge with the Registrar of Companies a notice in the prescribed form within 30 days of the purchase.

Following on the coming into force of the Companies (Amendment) Act 1998, the Inland Revenue Authority of Singapore (IRAS) issued *Interpretation and Practice Note 34*[53] setting out its position on the income tax treatment of share buy-backs. The IRAS takes the view that as long as a distribution to the shareholder is out of a company's distributable profits, it is a payment of dividends. As a company is able to engage in share buy-backs using only its distributable profits, the IRAS considers every case of share buy-backs to be a payment of dividends, not a repayment of capital. Whether such a position is consistent with *Trevor* v *Whitworth*[54] is a nice question since the decision in *Trevor* v *Whitworth* rests on the premise that a share buy-back is a return of capital to the shareholders.[55] However, as we shall see afterwards, the imputational tax treatment of corporate earnings and dividends distribution, together with tax rates applicable to individuals and corporations, favours shareholder-taxpayers who pay less than corporate rate of taxation.

The IRAS makes a distinction between a market purchase and an off-market purchase. Where a company buys back its shares on the stock exchange ("a market purchase"), the IRAS does not treat the proceeds of the disposal as a dividend. Whether or not the proceeds in the hands of the shareholder are taxable under the Income Tax Act will depend on whether they are of an income or capital nature. That is, the proceeds are not taxed under Income Tax Act section 10(1)(d) though it remains susceptible to income tax under some other head of section 10. Thus, a financial institution whose normal course of activity involves dealings in securities will have the gains from a disposal computed as part of its assessable income because the gains are taxable as business profits under section 10(1)(a). For other business corporations, whether or not the gains are taxable as income depends

[53] IRAS Compass, 31 December 1998 Vol 6 No 3.

[54] (1887) 12 App Cas 409.

[55] The significance of the income vs capital distinction in Singapore lies in there being no capital gains tax in Singapore. Other jurisdictions deal with the issue of share buy-backs explicitly in the statutory provisions. *UK*: see Income and Corporation Taxes Act 1988 s 209(2)(b), ss 219-229. *Australia*: Income Tax Assessment Act 1936 (ITAA36) Div 16K ss 159GZZZJ to 159GZZZT. (On-market share buy-backs – proceeds not to be treated as dividend (s 159GZZZR) but as consideration in respect of sale of shares (s 159GZZZS); off-market share buy-backs – difference between purchase price and debit against amount standing to the company's share capital account treated as dividend paid to shareholder (s 159GZZZP(1)). *New Zealand:* Income Tax Act 1994 CF2(1)(g)(i) (definition of 'dividends' includes 'acquisition by the company of shares in the company'; for exclusions, see CF3(1)(b)). Whereas the IRAS' treatment of on-market share-repurchase found in para 7 to *Interpretation and Practice Note 34* rests on the premise that the distribution is a dividend, the New Zealand tax legislation put the issue beyond doubt by the definition of 'dividends'.

on whether the share dealings amount only to investments, or to a business dealing in shares.[56] In the hands of an ordinary individual, the profit or gain from the sale of shares is normally considered to be in the nature of capital rather than income – unless the dealings are carried out with such regularity or system as to constitute a trade or business.[57]

In an off-market purchase, however, the IRAS treats the proceeds of the buy-back coming into the hands of the vendor-shareholder as a dividend. Under the imputational system adopted in Singapore, the amount assessable to income tax is the grossed up amount of the dividend. With the current corporate tax rate at 26%, the gross up factor is 100/74. At the same time, the vendor-shareholder receives a tax credit for the tax already levied on the corporate income. Assuming that tax-payer T sells 1,000 shares at $10 each to the company in an off-market buy-back scheme, the computation is as follows:

Proceeds received from share buy-back	10,000
Gross dividend ($100,000 x 100/74)	13,514
Assessable income (grossed up dividend)	13,514
Assuming 20% tax, tax assessed	2,703
Tax credit	(3,514)
Tax refund	(811)

Thus in addition to the purchase price received from the company for the repurchased shares, the company also receives a tax refund from the IRAS representing the difference between the corporate tax rate and his individual tax rate on the gross dividend. If his marginal tax rate is 20%, he receives $811 in addition to the $10,000 received from the company.

A tax-payer stands to benefit more if his marginal tax rate is lower. For example, if his marginal tax rate is only 10%, his tax assessed on the dividends will be $1,351 (10% x 13,514). Tax credit for the tax paid on the gross dividend is $3,514. His tax refund would increase to $2,163 ($3,514 less $1,351), a significant increase from $811 for the tax payer whose marginal tax is 20%.

It is only the individual tax-payer whose marginal tax rate exceeds the corporate tax rate who will suffer a tax loss on the dividend received. At present this would be a taxpayer whose chargeable income is above $400,000; the marginal tax rate on chargeable income above $400,000 is 28%. As

[56] *OUF Pte Ltd* v *Comptroller of Income Tax* (1998) MSTC 5,266.

[57] *MB Brash V C of IT* Appeal No 21 of 1959, Court of Appeal. *See Singapore Master Tax Guide Manual 1998* para 888.

such, a tax-payer in this bracket would pay an additional 2% on the gross dividend:

Proceeds received from share buy-back	10,000
Gross dividend ($100,000 x 100/74)	13,514

Assessable income (grossed up dividend)	13,514
Assuming 28% tax, tax assessed	3,784
Tax credit	(3,514)
Tax payable in respect of share buy-back	270

For the majority of taxpayers whose marginal tax rate on additional income do not breach the corporate tax rate of 26%, the share buy-back has an added attraction – the tax credit more than sets off the tax that they would have to pay on the 'buy-back dividend'. A corporate shareholder tendering shares for buy-back would be indifferent to the tax credit because the tax credit is equivalent to the tax he has to pay on the 'buy-back dividend'. Similarly an individual tax-payer whose marginal tax rate is 26%.

For the tax-payer whose gains from share trading is subject to income tax, the position adopted by IRAS has a possible added attraction – the pro-rating of the cost of repurchased shares amongst the remaining shares. The base cost attributed to the remaining shares is increased. As such, the taxpayer stands to benefit from the increased base cost that may be deducted against the price in a subsequent sale of the shares. An example usefully illustrates this.

> Assume that shareholder S has 30,000 in B Co which he purchased for $6 each. Through an off-market purchase, B Co buys back from S 10,000 shares at $10 each. The buy back price is treated as a dividend (see above). The capital cost of the repurchased shares is pro-rated to the remaining shares:
>
> cost of repurchased shares
> no of shares remaining after repurchase
>
> = ($6 x 10,000) / 20,000
> = $3
>
> The cost of each of the remaining shares will be $6 + $3 = $9. If the shareholder subsequently sells all his remaining 20,000 shares for $10,000 each, his taxable gain will only be $1 per share, instead of $4 per share.

From the perspective of the shareholder, the attractions of an off-market acquisition at $10 per share outweigh the attractions of an on-market acquisition at the same price because of the tax credit given. The attractions increase if the shareholder's gains from share trading are taxable as trade or business income as his base cost for the remaining shares will be increased to his advantage.

From the perspective of a company contemplating buy-back of its shares, the tax benefit granted by the tax system to the selling shareholder helps to reduce the price that might otherwise be payable. A company might be able to buy back shares in an off-market transaction at a lower price than on the open market because of the additional tax benefit granted to the taxpayer under the imputational system. Assume the share to be trading at $11.00 on the open market. Given no further market movement, the company will have to pay at least $11.00 if it were to engage in an on-market purchase. In an off-market purchase, the company might offer less and yet make it more attractive for the shareholder. Assume that the company offers to buy back shares for $10.00. The tax credit to each shareholder who sells back shares to the company would be $3.51. Assuming that the marginal tax rate for the shareholder is 10%, he would have to pay tax of $1.35 on the grossed up dividend of $13.51. He gets a tax refund of $2.16. The net cash flow per share to him would be $10 from the company and $2.16 from the tax authorities, a total of $12.16. A very attractive proposition indeed. Thus the more shareholders a company has in the lower tax brackets, the more the tax credit would help subsidize the price which it might otherwise have to pay for the shares.

7. *Implication of tax treatment of share buy-backs for directors' duties*

The tax consequences under the current approach adopted by the IRAs has potentially important implications for the legal duties of directors and corporate managers. The tax credit given to shareholders for the corporate tax already paid by the company, together with the tax on the grossed up earnings distributed as the repurchase price of the shares at the personal income tax rate of the shareholder, has the following consequences that a competent corporate manager has to bear in mind when deciding on the mode of repurchase:

(1) In a off-market share repurchase, the tax system provides an additional cash-flow which may be used to subsidize the price that the company otherwise has to pay for the shares. This tax subsidy is not available in an on-market share repurchase.

(2) The benefit of the tax subsidy varies with the type of shareholder holding the shares to be repurchased. Taxpaying shareholders in the lower tax brackets obtain a larger tax subsidy. Shareholders whose marginal tax rate is equivalent to the corporate tax rate (*ie*, 26%) obtain no tax refund from the IRAS. At the other end of the spectrum, individual shareholders whose marginal tax rates fall into the highest bracket (*ie*, 28%) would have to pay an additional 2% on the gross up on the earnings distributed as the repurchase price.

It is in the interest of both the company and the shareholder to appropriate the benefit of this tax subsidy available only in an off-market repurchase. Absent strong countervailing reasons, the company should prefer an off-market share repurchase scheme to an on-market share repurchase scheme. This enhances the cash-flow to the shareholder. At the same time, it potentially allows the company to avoid paying the premium otherwise necessary to ensure the success of its share buy-back scheme. This may take the form of a reduced premium, avoidance of a premium altogether or even a discount on the market price. The company's managers should therefore gather a profile on the shareholders of the company, make an estimate of the number of potential beneficiaries and then make an assessment of how the company can benefit from this tax subsidy. If 40% of the company's shares are held by shareholders holding no more than, say, 10 lots each, it is reasonable to suppose that these shareholders are less likely to be in highest tax brackets and would be likely to benefit from an off-market share buy-back. If a company intends to buy-back 10% of its shares, it can quite assuredly succeed by offering only the market price of the shares to these shareholders – if only the tax benefit is explained to them.

The coincidence of interest between the company and the shareholders to appropriate the tax subsidy must necessarily translate the preceding considerations into legal duties. I suggest that a company which seeks shareholder approval for an on-market share repurchase scheme must therefore have a duty first, to consider an off-market share repurchase and second, when seeking authorization from shareholders to make on-market repurchase authority, to explain why an on-market purchase is preferred to an off-market share repurchase. These duties must necessarily arise from the interaction of the new share buy-back provisions and the tax treatment of share buy-backs. It would be insufficient for the company merely to set out why a share buy-back is desirable from the perspective of the company. The company and its directors should have a duty to explain their choice of an on-market purchase over an off-market purchase.

In an off-market repurchase offer, the board must disclose how a shareholder stands to benefit from the tax subsidy. By explaining to the individual shareholders the potential tax refund which can only be appropriated if the shares are repurchased by the company, the company can offer a lower price than it otherwise would have to offer without the disclosure. The directors' duty to act for the benefit of the company demands this. This will also be a practical translation into legal duty of the financial precept that corporate managers have a duty to maximise shareholder values. The omission to make adequate disclosures and explanations on this matter should not only attract to the directors the odium of incompetence, it should amount to actionable negligence by the company.

8. *Implications under the Singapore Code on Take-overs and Mergers*

A share buy-back, in reducing the number of outstanding shares, increases the percentage holding of the remaining shareholders. A company that buys back 10% of its shares will increases the stake of a shareholder who already holds 24% to 26.67% (= 24/90); a shareholder who initially holds 45% of the shares will find his stake increased to 50%.[58] Under Rule 33 of the Singapore Code on Take-overs and Mergers ("the Code"), a mandatory take-over obligation is triggered when a person, together with parties acting in concert,[59] acquires voting shares in a public company which increases his voting rights either from below 25% to above 25%, or (where their initial stake is between 25% and 50%) by 3% in any 12 month period. To provide guidance to directors and shareholders on their obligations upon a buy-back which has the effect of causing a shareholder to cross the 'thresholds' set out in Rule 33, the Securities Industry Council (SIC) on 20 November 1998 issued Practice Note No 13: Offer Obligations Resulting from A Share Buy-back. ("PN13").

The SIC takes the position that an increase in the percentage of voting rights held by a shareholder and persons acting in concert with him is an acquisition for the purposes of Rule 33.[60] The obligation to make a mandatory bid in Rule 33 could apply if the relevant voting percentages are increased even though the parties take no active steps to acquire the shares for themselves. Parties whose percentage of voting rights would, by reason of a share buy-back, increase and reach the thresholds contemplated by Rule

[58] 45/100 to 45/90.

[59] "Persons acting in concert comprise individuals or companies who, pursuant to an agreement or understanding (whether formal or informal), co-operate, through the acquisition by any of them of shares in a company, to obtain or consolidate control of that company...": Definition, The Code.

[60] PN 13 para 1. This is similar to UK City Code on Take-overs and Mergers, Rule 37.1.

33 are therefore well advised to consult the SIC beforehand on whether a exemption can be obtained.[61]

To seek an exemption, directors and persons acting in concert with them must ensure that certain conditions are complied with. If an exemption has been granted, a breach of any of these conditions invalidates the exemption. These conditions are:

(a) the circular to the shareholders must advise shareholders that in voting for the buy-back resolution, shareholders would waive their right to a general offer which arises by reason of the directors and persons acting in concert with them increasing their voting rights in the manner set out in Rule 33;[62]

(b) the names of the directors and the persons acting in concert are to be disclosed in the above circular;[63]

(c) the circular must disclose the voting rights of the individual directors and persons acting in concert with them at the time of the resolution *and* after the proposed buy-back;[64]

(d) (in a market acquisition or off-market acquisition on an equal access scheme) the resolution must be approved by a majority of shareholders present and voting who would not fall under an obligation to make a mandatory bid by reason of Rule 33; (in a selective off-market repurchase scheme) the resolution must be approved by three-quarters of those present and voting and who would not fall under an obligation to make a mandatory bid by reason of Rule 33;[65]

(e) neither the directors nor persons acting in concert with them may vote or recommend to shareholders to authorise the resolution;[66]

[61] It is clear that the SIC intends parties to consult if there is any question in this regard: PN 13 para 1.

[62] Listed companies: PN 13 para 2(a). Unlisted companies: PN 13 para 3(a).

[63] Listed companies: PN 13 para 2(a). Unlisted companies: PN 13 para 3(a).

[64] Listed companies: PN 13 para 2(a). Unlisted companies: PN 13 para 3(a).

[65] Listed companies: PN 13 para 2(b). Unlisted companies: PN 13 para 3(b).

[66] Listed companies: PN 13 para 2(c). Unlisted companies: PN 13 para 3(c).

(f) neither the directors nor persons acting in concert with them may acquire shares when they know that despatch of the notice of the resolution to authorise the share buy-back is 'imminent'.[67]

Shareholders not acting in concert with the directors are not required to make a mandatory bid under Rule 33 even if the thresholds contemplated by Rule 33 are breached. They are not disqualified from voting on the buy-back resolution even though the buy-back would have the effect of increasing their voting rights from below 25% to above 25%, or by 3% in any 12 month period. However a shareholder who is not acting in concert with the directors is required to make a mandatory bid under Rule 33 under any of the following scenarios:

(a) where a shareholder and persons acting in concert with him would increase their voting rights to 25% or more, and the parties acquire shares between the date of the notice of the resolution and the date on which the next annual general meeting is or is required to be held;[68]

(b) where a shareholder and persons acting in concert with him already hold between 25% and 50% of the company's voting rights, and the buy-back would result in the parties increasing their voting rights by 3% in the preceding 12 months, the parties purchase shares between the date of notice of the resolution and the earlier of –

(i) the date on which the next annual general meeting is or is required to be held, or

(ii) the date on which the company has completed the repurchase according to the terms of the authorisation, or the date on which the company decides to cease further repurchase of its shares;[69]

(c) where a shareholder and persons acting in concert with him already hold between 25% and 50% of the company's voting rights and the buy-back would result in the parties increasing

[67] Listed companies: PN 13 para 2(d). Unlisted companies: PN 13 para 3(d).

[68] PN 13 para 5(a).

[69] PN 13 para 5(b). The clearest instance of a decision is when the board of a company makes a resolution to cease further buy-back of the company's shares. See also PN 13 para 9 which requires companies to promptly inform their shareholders of such a decision.

their voting rights by less than 3% in the preceding 12 months, the parties acquire shares when the resolution is in force which when taken together with the increase in voting rights resulting from the buy-back would exceed 3% in the preceding 12 months;[70] or

(d) where "one of the main purposes for undertaking a share buy-back is to assist any shareholder and his concert parties in obtaining or consolidating control of the company".[71]

An important consideration is the issue of when a person's obligation to make a mandatory bid under Rule 33 is triggered. This is tied in with the question of the price at which the mandatory bid is to be made. The Practice Note lays down the rule that where directors and their concert parties come under a potential liability to make an offer under Rule 33 and an exemption is either not granted or is invalidated, the obligation to make the mandatory bid arises upon the company buying back the "relevant" number of shares[72] or upon the exemption being invalidated.[73] When a share buy-back triggers a mandatory bid under Rule, the offer to be made by directors and their concert parties is to be in cash (or accompanied by a cash alternative); further, the price to be offered is the higher of (i) highest price for the shares paid by the directors and his concert parties in the preceding 12 months, or (ii) the highest price paid by the company pursuant to a valid authority to repurchase shares.[74] In the case of shareholders not acting in concert with directors, the offer price is to be the highest price paid for the shares by the shareholder and his concert parties in the preceding 12 months.[75]

The share buy-back is one of the potential devices that may be used by a company to defend itself against a take-over bid.[76] To prevent the

[70] PN 13 para 5(c).

[71] PN 13 para 5(d).

[72] Presumably, the number of shares that would cause the shareholder and his concert parties to cross the thresholds set out in Rule 33.

[73] Para 6.

[74] PN 13 para 7.

[75] PN 13 para 7.

[76] For example, by a buy-back of 10% of the company's issued shares, the company can increase the voting rights of a shareholder from 45% to 50%. A company can also reduce the prospect of a successful take-over by buying back the shares of those who might otherwise tender to the hostile bidder.

misuse of share buy-backs as a defensive mechanism, the Practice Note[77] requires the board to cease the buy-back of the company's shares during the course of an offer until further approval from shareholders at a general meeting is obtained. The same applies when the board has reason to believe that a *bona fide* offer is imminent. Again, directors and concert parties are not permitted either to vote or to recommend to shareholders to vote in favour of the approval. However, the obligation to suspend buy-backs pending further approval from the company at a general meeting is not required when the board is carrying out of an existing selective share buy-back agreement approved under section 76D.

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[77] PN 13 para 11.

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