CORPORATE

Buying shares back in? Share buybacks: what, where and how

BEYOND™ CORPORATE LAW

Overview

This factsheet provides a brief overview of the main considerations associated with a buyback of shares, including the various reasons for carrying out a buyback, and some of the pitfalls a company should be wary of with the process.

In its simplest form, a share buyback is a transaction whereby a company purchases its own previously-issued shares back from the shareholder to whom they were issued.

Whilst it may seem counter-intuitive for a company to spend money repurchasing shares it has previously issued to its shareholders, there is often a strong commercial rational for doing so. We begin this factsheet by considering this question in more detail.

Main reasons for buying back shares

Re-gain ownership slice

As a general rule, shares commonly carry with them voting rights in the company in which they're issued, and ultimately it is the shareholder voting rights that give control over the company. The company may therefore want to regain the slice of ownership previously sold to the shareholder, and tighten the reins on its direction.

Return of value to shareholders

A company may, at any given time, have surplus cash which it does not have any specific planned use for. This can happen in a variety of circumstances - for example, the company may have increased profitability/cash recovery, or may have sold of part of its business.

Should the company not plan to reinvest this cash or have any other plans for it, it can re-purchase shares from the shareholders as owners of the company, returning value in a similar way to paying out a dividend. Depending on the makeup of the shareholder base, this could be done with a view to maintaining good shareholder relations and potentially incentivising further investment in future.

Shareholder exit route

A buyback may be proposed by the shareholder rather than the company, and for many reasons, which could include:

- a loss of faith in the directors, or a difference of opinion as to the direction in which the board are taking the company;
- disagreements with other shareholders;
- retirement; or
- to alleviate themselves from the voting/decision-making obligations of a shareholder.

In this context, therefore, a buyback provides a shareholder with both a return of value and an exit from the company.

Increasing profit per share

Essentially doing the opposite of share dilution, by reducing the number of outstanding shares in issue, the company can increase the earnings per share ratio on its issued shares. This is due to the annual earnings of the company then being divided over a lesser number of outstanding shares.

Generally less relevant to smaller/privately-owned companies (where profit per share is a relatively rare measure of performance), this may nonetheless be a consideration for larger businesses: profit-per-share is, for example, one significant driver of share value for listed businesses.

Types of buyback

Purchase of own shares

With this approach, a company buys back its own shares, which are then either immediately cancelled (and the company's issued share capital reduced accordingly) or held by the company for future issue to new or existing shareholders. Where a company holds its own shares in this way, these are referred to as shares held in treasury.

Share redemption

Whilst companies will generally have some variation of 'ordinary' shares issued (usually a share which is entitled to full voting rights), they will often have a variety of differing share types.

Some of these shares may be 'redeemable', i.e. the company has agreed on their issuance that they can be redeemed. This may be on a fixed date in the future, or at the directors' or shareholders' discretion. Creating and issuing shares of this type can enable a company to be flexible when reducing share capital, and can provide a pre-prescribed exit route for shareholders.

Outline of the process

Step 1 - restrictions

As a first step, a company planning a buyback will need to ensure that its current articles of association do not restrict or prohibit the purchase of their own shares. If such an obstacle exists, then a special resolution (a vote of a 75% majority of shareholders) will be needed to amend the articles by removing the restriction.

Transfer restrictions should also be considered. Commonly, so-called 'pre-emption rights' are set out in a company's articles, requiring shares which are being transferred to be offered first to existing shareholders. If a company wants to take back its own shares, then any such pre-emption provisions would need to be waived, amended or removed.

Step 2 – share capital

The company must further ensure that the shares it plans to purchase are fully paid up – meaning in broad terms that they have been paid for in full. There are ways to address the position if any shares to be bought back are only partly-paid. These are outside the scope of this factsheet, but are relatively straightforward.

Step 3 - finance

The company must ensure it will have adequate funds to pay for the shares being acquired. We deal in further detail below with the methods of financing a buyback for a limited company.

Step 4 – transaction documents

A buyback contract will be required, which the company (purchaser) and the shareholders currently holding the shares (sellers) are party to. This will set out the terms of the agreement, including how many shares are being purchased and at what price. The parties may negotiate further terms contained within the buyback contract, depending on the context and each party's bargaining power.

Under the relevant parts of the Companies Acts governing the buyback regime, the share buyback contract will need to be approved by a resolution of the shareholders of the company, either at a meeting or in writing.

Step 5 - completion

Typically, completion of the buyback takes place when the agreement is signed, at which point the selling shareholder will return his share certificate (or an indemnity where this cannot be done) and the company will make payment of the purchase price of the shares it is buying back. A key consideration is that it is not possible to defer all or any part of the payment for the shares, in a buyback context. This differs from a straightforward transfer of shares between 2 parties, where it is common for part of the purchase price to be deferred to a date after completion, and sometimes subject to agreed payment conditions.

Step 6 – post-completion

Companies House filing obligations should be attended to after the buyback has completed.

As a final comment under this section of this factsheet, it should be noted that there are certain further considerations to be borne in mind when a buyback is contemplated within the context of an employee share scheme. These are outside the scope of this guide.

Financing a buyback

A company may finance a share buyback using one of the following mechanisms, subject to any restrictions imposed by their articles of association or any shareholder agreements in operation:

Distributable profits – a buyback can be funded from a company's profits which are available for distribution – a measure derived from a company's balance sheet. This is the most common and straightforward method of funding.

Capital – a buyback can be funded out of capital rather than profits. This affects a company's balance sheet in a different manner, and is subject to a more rigorous process imposed by law, with a view to protecting a company's creditors. Subject to certain exceptions, a buyback out of capital requires a

written statement of the directors giving an opinion that the company will still be able to cover its debts directly after the purchase and carry-on business as a going concern. An auditor's report on the company must also be annexed to the directors statement.

Proceeds of a fresh issue of shares – rare in practice, but new shares can be issued to fund the purchase of older shares.

Void buyback & consequences

Contravention of Part 18 of the Companies Act 2006 (the relevant legislation governing this topic) can lead to share buybacks being unlawful and thus void. This can create significant issues, and does so in practice – the technical requirements associated with a buyback are an area where errors are quite often made. The purported transaction is treated as never having taken place, with the effect that the selling shareholder may be deemed hold the purchase price paid for those shares by the company on trust for the company, and thus be obligated to return the full sum.

Furthermore, there is no time bar on a void buyback, so ensuring this is corrected is of great importance to the prospects and longevity of the business.

Put into the example context of an acquisition, where a buyer of a company is examining all aspects of the target business, if that company has effected what amounts to a void buyback transaction, it can be highly damaging to the sale process – largely because of the time and process associated with the exercise of unravelling the defective buyback.

If you would like to discuss any of the aspects of this factsheet, please get in touch.

For further information or to a arrange a free, no obligation consultation, then please contact our team on:

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