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CORPORATE KNOW-HOW

# SHARE BUYBACKS: WHAT, WHY AND HOW

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WHAT DO YOU NEED TO KNOW?

# SHARE BUYBACKS: WHAT, WHY AND HOW

## WHAT IS IT?

**Put simply, a share buyback is where a company purchases its own shares from an existing shareholder. Upon a share buyback, the relevant shares are either cancelled by the company or held "in treasury", i.e. with their rights suspended until transferred to a new shareholder. In this guide, we will look at some key aspects of share buybacks in relation to private limited companies incorporated in England & Wales.**

### Why use a share buyback?

Subject to any restrictions imposed by a company's articles of association and any shareholders' agreement, the shareholders of a private limited company are free to sell their shares to existing shareholders or third parties. Where there are no third parties interested in investing or the remaining shareholders do not have funds available to buy out the exiting shareholder, a company funded buyback of some or all of the shares held by particular shareholders can be a useful option. Alternatively, a share buyback can be an effective way of transferring excess profits to shareholders where other distribution options, such as special dividends, would not receive favourable tax treatment.

### How are they funded?

There are three main ways of funding a share buyback, these are:

- Profits: Using the distributable profits held in the business, one of the simplest and most common ways of funding a buyback.
- Capital: Where insufficient distributable profits are available to fund a buyback, a private company may use other funds within the business, provided that using such funds does not lead the company into financial difficulties.
- Issue of shares: Where existing shareholders or third party investors wish to subscribe for shares in the company, the proceeds received from the share issue can be used to fund the buyback of shares from a shareholder who wishes to exit.

### How long does it take?

Generally, the funding arrangements for the share buyback can have the most significant impact on the length of time it can take to reach completion. The fastest option is usually a buyback funded out of profits which, outside of any regulatory approval required, can be completed within days of the final documents being agreed. In contrast, buybacks out of capital must follow a lengthy statutory process that can take 5 weeks or more, even after any regulatory approval has been obtained and documents relating to the buyback agreed. The process of funding a buyback from the issue of new shares sits somewhere between the two above options, with the timeline to completion depending on how quickly the new shares are issued and how long a gap is left before the buyback is completed.

In light of the differing timescales, it is important to ensure that the urgency of any buyback arrangement is considered carefully, as in some circumstances it may be best to look at other ways of facilitating the exit of a departing shareholder that are more suited to the desired timeline of the parties.

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## Do I need a contract?

Unless the buyback relates to an employees' share scheme, a written share buyback agreement must be drafted and approved by the company's shareholders before the buyback takes place. The agreement should set out the key terms of the share buyback, including the name of the selling shareholder, the number and class of shares being sold and the price to be paid per share. Alternatively, buyback terms may be set out within the articles of association of the relevant company, however, this is most effective where the buyback is planned long term, with a clear pricing mechanism and fixed timeline, hopefully avoiding the need to continuously revisit and amend the articles. Where share buybacks are being completed simultaneously with multiple exiting shareholders, it is common to prepare individual agreements so they can be approved independently of one another, helping to reduce the overall impact of any individual buyback being rejected.

## What if my company works in the defence sector?

If your business works within certain sensitive economic areas such as defence, national infrastructure or cutting-edge technologies, transactions relating to the company's shares may be captured by restrictions within the National Security Investment Act ("NSI Act") – even where there is no new third party. If the proposed share buyback is going to result in a change of control in the company - perhaps taking one shareholder's control of voting rights from 25% to above 50% - a mandatory notification of the transaction to the Cabinet Office may be required. A transaction that is not properly notified under the NSI Act can be declared legally void and can result in civil and criminal penalties being imposed on the responsible parties – of particular concern for the directors of the businesses involved. If you are concerned that your business activities and proposed buyback might be captured under the NSI Act, it is a good idea to pause, take advice and potentially make a voluntary notification than risk the consequences of forging ahead without the required approval.

## Conclusion

Share buybacks are complex and require specialist advice on the tax, accounting and legal matters involved. Nevertheless, internal company arrangements such as buybacks can be much more straightforward where the parties are aligned on the purpose and terms of the transaction before engaging professional advice. Working with the parties to reach a provisional agreement on the number of shares to be purchased and the price per share can go a long way towards managing costs and ensuring the buyback proceeds smoothly.

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Whether you are leaving a business, looking to buy out a departing shareholder or advising someone who is, our specialist Corporate lawyers would be happy to provide you with the support you need at any stage in the process.


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