

# Policy Issues Underpinning the Concept of Par Value: A Comparative Legal Study

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'Stock (shares) which was issued without a corresponding pay-in of assets valued at an amount equal to par was called "watered stock" - stock issued not against assets but against water... It must be emphasised that concepts of watered stock..., and the doctrines that came to surround them, were and are limited in application to the *issue* of stock, that is, sales by the *corporation* of its own stock. The doctrines do not in any way inhibit the *shareholder's* freedom to sell his stock at any price he can get, or to give it away if he wishes. Similarly, a corporation holding shares of another corporation may, like any other shareholder, dispose of them at any price it wishes or can get. The reason why shareholders were held to pay in the par value of their shares is that that was the price exacted by the law for the corporate advantage of limited liability.<sup>1</sup>

The concept of par value of company shares denoted the minimum amount by which the shares could be purchased.<sup>2</sup> However, even if the law exacted a price for the advantage of limited liability to the shareholders, taking into account the net worth of the company, it was not easy to maintain a constant equilibrium between the nominal capitalisation of the company and the value of its assets. The value of the assets, with time, may depreciate or appreciate. Indeed, if this were to happen then the value of the assets of the company could cease to have a corresponding value to the original share-

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<sup>1</sup> R W Hamilton, 1989, *Corporation Finance: Cases and Materials*, West Publishing, St Paul, Minn, p 75. The reason for giving shares a par value is mainly historical. At a time when it was envisaged that the nominal value of shares would be so large that a substantial proportion would be left uncalled, the introduction of the par value concept was a convenient yardstick to measure the extent of liability of shareholders. For an elaborate discussion on this view, see for example, *Final Report Of The Committee Of Inquiry Into The Working And Administration Of The Present Company Law Of Ghana*, 1961, 'Gower's Report', Government Printers, Accra, p 53.

<sup>2</sup> See *Orregun Gold Mining Co Of India v Ropley* [1892] AC 125.

capital employed. To this extent, it could be argued that any monetary pricing introduced as a signal to the market of the value of a share in the equity of a company is almost always a fiction and may not only be meaningless but also misleading.

This paper examines the policy issues underpinning the legal aspects of par value of company shares. A comparative approach to the law is undertaken. The paper argues that the concept of par value has little relevance in the world of commerce today and that shares of no-par value often reflect the true value of the shares.

### **Allotment of shares and the Par Value Concept in England**

Under the Companies Act 1985 of the United Kingdom, a company limited by shares must state in its memorandum of association the division of the share-capital into shares of a fixed amount.<sup>3</sup> The nominal amount of each share is what is known as the *par* value.<sup>4</sup> The English Companies Act 1985 permits a company to state its nominal capital and the value of its shares in any currency, provided that in the case of a public company the nominal capital with which it is registered must include £50,000.<sup>5</sup>

While the concept of par value might be relevant to primary issues of securities in both private and public companies (eg at incorporation), that is not necessarily true for secondary trading of securities. In the case of secondary trading, *par value* might only be useful to issues in private companies, but not to issues in public companies. One of the reasons supporting this view is that in many countries shares in a public company are traded on a stock exchange. Since for the most part of this stock market trade the public can purchase shares in such companies, it is the market itself that will be expected to set the price of the shares. BonBright argues that the purpose of the par value concept is not to reflect the market value of the enterprise, which is constantly shifting and which therefore cannot be set by the face value of the share certificate, but to indicate the capital that the

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<sup>3</sup> English Companies Act 1985, s 2(5)(a).

<sup>4</sup> See *Oregum Gold Mining Co of India Ltd v Roper* [1892] AC 125.

<sup>5</sup> English Companies Act 1985, s 117 and 118.

shareholders have agreed to contribute.<sup>6</sup> This feature is alluded to by BonBright as being historical and therefore fixed.<sup>7</sup>

Another view supporting the policy basis of having the par value system is that in order for creditors of a company to be confident that the corporation will pay off its debts, when in financial distress, the par value is seen as a basis upon which the share-capital account of the debtor company can be based. Also, the par value prevents arbitrary valuation of shares in excess of their true value. Pennington adds that the nominal value of shares is useful in declaring dividends (usually expressed as a percentage of the nominal value), determining voting rights at meetings of shareholders and, in the case of preference shares which have priority for repayment of capital, determining the amount which must be paid to the preference shareholder in winding up before the company's remaining assets are shared between the ordinary shareholders.<sup>8</sup>

The general rule under the English Companies Act 1985 is that when shares are allotted they have to be paid-up in full.<sup>9</sup> Payment must be in money or money's worth, including goodwill and know-how.<sup>10</sup> Shares are deemed to be paid-up in cash if the payment received by the company is in cash or is a cheque received in good faith and the directors have no reason for suspecting that it will not be paid.<sup>11</sup> Also, payment in cash could involve an undertaking to pay cash to the company at a future date.<sup>12</sup>

Another general rule applying to both private and public companies is that no share can be issued at a discount.<sup>13</sup> Section 100 of the English Companies Act 1985 provides:

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<sup>6</sup> J C BonBright, 'The Dangers Of Shares Without Par Value' *Columbia Law Review*, 24 (1924), p 449.

<sup>7</sup> *Ibid*, pp 448-450.

<sup>8</sup> R Pennington, 1990, *Pennington's Company Law*, London, Butterworths, p 21.

<sup>9</sup> English Companies Act 1985, s 99(1).

<sup>10</sup> *Ibid*, s 99 (1).

<sup>11</sup> *Ibid*, s 738 (2).

<sup>12</sup> *Ibid*, s 738.

<sup>13</sup> *Ibid*, s 100.

- 1) A company's shares shall not be allotted at a discount.
- 2) If shares are allotted in contravention of this section, the allottee is liable to pay the company an amount equal to the amount of the discount, with interest at the appropriate rate.<sup>1</sup>

In other words, shares cannot be issued as fully paid up at a consideration below their nominal value. Where shares are paid-up at a discount, the allottee will be liable to pay the allotting company an amount equal to the amount of the discount, with interest at an appropriate rate.<sup>14</sup> Where the allottee has already sold the shares, the subsequent holder of the shares will be liable to pay the company an amount equal to the amount of the discount, with interest at an appropriate rate.<sup>15</sup> The subsequent holder is, however, allowed a defence if he can show that he is a bona fide purchaser for value and without actual notice.<sup>16</sup> Directors and any officer of the allotting company who are responsible for the allotment will be liable to a fine.<sup>17</sup>

The principle that shares must be paid-up in full must be seen as important not only in safeguarding efforts to raise company finance, but also in ensuring that fair trade in securities takes place. To hold otherwise would amount to condoning 'share watering' and thereby putting the existing shareholders and the creditors at a disadvantage. It is submitted that if a case of collusion between an allottee and the directors of the allotting company were to occur, for purposes of issuing shares at a discount (while the company is a going concern), the remedy must not only be in making the allottee pay an amount equal to the discount. The allottee must also be made to forfeit his right to hold shares - only with regard to those shares acquired under the transaction - since he has shown that he can undermine the company by entering into dubious transactions. This proposal is made in the light of the fact that the law in the United Kingdom is silent on the fate of an allottee who subsequently makes a payment equal to the discount on the share price. It is submitted further that although the English Companies Act 1985 provides for statutory provisions governing the law on payment for shares, the statute does

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<sup>14</sup> English Companies Act 1985, s 100 (2).

<sup>15</sup> *Ibid*, s 112.

<sup>16</sup> *Ibid*, s 112(1) and (3).

<sup>17</sup> *Ibid*, s 114.

not deal with situations relating to share price discounts on a single share. Section 100 of the English Companies Act 1985 covers only situations relating to the allotment of more than one share:

'A company's shares shall not be allotted at a discount...'

What happens where only one share is allotted at a discount? It is submitted that since an issued share is part of the share-capital, the directors of the company, as persons who manage or who are custodians of assets of the company, have unquestionable fiduciary duties towards the corporation they direct.<sup>18</sup> On this basis, the directors can be held liable for breach of fiduciary duties if they allot one share at a discount.<sup>19</sup>

### Arguments Countering the Par Value System

The concept of par value has received some criticism from a number of scholars.<sup>20</sup> Among these criticisms is the problem associated with issuing shares for considerations other than cash. What happens where shares are issued in return for services or in return for goods? How do we determine if the services or goods are at par with the nominal value of the shares?

Another difficulty facing the concept of par value is the attitude of the courts towards this concept.<sup>21</sup> In the American case of *Commonwealth v Leigh Av Ry Co*,<sup>22</sup> the court overlooked the applicable par value and adopted an arbitrary value based on the amount paid to the company. In that case, a company was 'capitalised' at US\$1,000,000 altogether. The charter of the company provided that the company could not issue bonds in excess of 50% of the par value of the shares. A suit was brought to enjoin an issue of

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<sup>18</sup> See J C Shepperd, 1981, *Law of Fiduciaries*, Carswell Co, Toronto, 1981, p 362. See also *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 and *cf Phipps v Boardman* [1966] 3 All ER 721.

<sup>19</sup> See generally cases cited in *supra* (n 18). See also generally P Loose, J Yelland and D Impey, 1993, *The Company Director: Powers and Duties*, Jordans, Bristol.

<sup>20</sup> For example, J C BonBright, *op cit*, p 3.

<sup>21</sup> See D Frederick, 1906-1907, *The Par Value Of Stock* *Yale Law Journal*, 16, p 249.

<sup>22</sup> 129 Pennsylvania St 405.

US\$250,000 of bonds and an injunction was then granted. The court declined to recognise the 50 dollars 'par value' established by the charter, and instead held that the five dollars per share received by the company was the real par value while the other figure was merely a 'nominal' value.

The courts have also disregarded the par value in instances where recognising par value would prejudice interests of the company. In *Handley v Stutz*,<sup>23</sup> a coal company 'capitalised' at US\$200,000, and with US\$120,000 of the shares unissued, became obliged to raise US\$50,000 in order to continue business. The issued shares had depreciated significantly in value and also no investor could offer 'full' value for the unissued shares. Therefore, bonds to the amount of the required sum, although not marketable by themselves at their principle value, were sold by giving an equal amount of the previously unissued shares at a bonus. The remaining US\$30,000 of the shares was then distributed among the old shareholders as a present. In a creditor's bill to compel payment in cash to the corporation at the par value of the new shares, the court declared as to the shares delivered with the bonds that 'an active corporation may, for the purpose of paying its debts and obtaining money for the successful prosecution of its business, issue the stock (shares) and dispose of it for the best price that can be obtained.'

In essence, what the above two cases show is that American courts are slowly developing a common law which makes share-watering lawful. The cases also point to a critical weakness in the use of the par value concept as a yardstick to measure limited liability of shareholders. Generally, an investor could be attracted to subscribe for the shares on the basis of the represented value of the shares and it is often this represented value that bolsters the price of the shares above their real value.<sup>24</sup> A great discrepancy between the value of the holdings of a corporation and the nominal value of capitalisation usually lends an opportunity to defraud inexperienced purchasers. Therefore, a shift inclined towards abandoning the par value system and adopting a no-par value system might be more efficient as it would put the investor on guard and thus avoid creating a false sense of investor protection.

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<sup>23</sup> 139 (1891) US 417, 11 Sup Ct 530.

<sup>24</sup> See C Allen, 1920, Non Par Value Stock 90 *Central Law Journal*, p 170.

## The No-Par Value Concept

Generally, the notion of issuing shares at no-par value can be traced to the joint stock companies of the Elizabethan period when shares were used 'in the natural sense, namely, as an appreciable part of the whole undertaking not as a multiple of units of the capital'.<sup>25</sup> Harmen, however, observes that the concept of no-par value originates from American jurisprudence.<sup>26</sup> He argues that in the US, company promoters often found themselves engaged in lawsuits to prove that some of the shares which had been allotted, although treated as fully paid-up, were in fact not fully paid-up. These lawsuits constrained functions of promoters and thus, to avoid such bottlenecks, companies were permitted to issue shares of no-par value.<sup>27</sup>

In the Gedge Report on Shares of No-Par Value the following three instances were identified as typical cases where shares can be issued for no-par value under the American legal system:<sup>28</sup>

'a) where the law only requires the certificate of incorporation to state the number of shares of no-par value to be issued, leaving it to the corporation to determine how much of the proceeds of issue of such shares should be allocated to capital and how much to distributable surplus;

b) where the law requires the certificate of incorporation to state the amount of the capital of the corporation which must include some minimum amount (for example US\$1.00) in respect of every issued share of no-par value. In such cases, any excess of the proceeds of issue

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<sup>25</sup> See generally C Allen, *ibid.* See also generally, V Morawetz, Shares Without Nominal Or Par Value *Harvard Law Review*, 26 (1913); and J E Goodbar, No Par Value Stock – Its Nature And Use *Miami Law Quarterly*, Vol. 3, No 1, (1948).

<sup>26</sup> M C Harmen, *Memorandum To Gedge Committee*, in the Board of Trade, *Report Of The Committee On Shares Of No Par Value*, Cmd 9112 of 1954 (The Gedge Report).

<sup>27</sup> See generally *ibid.* See also A A Berle, Problems Of Non Par Stock *Columbia Law Review*, 25 (1925), p 44 where he observes that the first authorisation for the issuance of shares of no-par value was made under Chapter 351 of the Laws of the State of New York in 1912. Since then other American states have enacted legislation to permit issuance of no-par value shares.

<sup>28</sup> See the Gedge Report, *op cit*, p 11.

of such shares over the minimum amount may in general be treated as a distributable surplus; and

c) where the law requires that the amount of capital stated must include the whole consideration received on the issue of shares of no-par value. In such cases there can be no distributable surplus. This system is permissible in New York and certain other states. But in Wisconsin, for example, an amount up to 25% of the proceeds of issue may be allocated to surplus.'

In New Zealand<sup>29</sup> and Canada,<sup>30</sup> the issuing of shares of no-par value is also allowed. In Ghana, following the Gower Report in that country,<sup>31</sup> the issuing of shares of no-par value is no longer forbidden. The case of Ghana, like that of New Zealand, shows that company legislation now requires that all shares should be issued at no-par value.<sup>32</sup> In Ghana, the Gower Report noted:

'...the main obstacle in rendering the true nature of a share in a company readily comprehensible to the man-in-the street is that fact that the present law insists that a nominal value should be attached to it...

At the commencement of a company's life par-value may be arbitrary and misleading, since shares may be issued at a premium or even (through an issue for a consideration other than cash) at a disguised discount. There after they become totally arbitrary; a so-called \$G1 share may if the company has made losses be worth anything from \$G1 to infinity. The retention of the misleading \$G1 symbol is an endless source of complication and confusion both to the sophisticated and

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<sup>29</sup> See the New Zealand Companies Act 1990, s 28.

<sup>30</sup> See the Canadian Companies Act 1934, s 12 (7).

<sup>31</sup> See generally *Final Report Of Commission Of Enquiry Into Working And Administration Of Company Law Of Ghana*, supra, (n 1).

<sup>32</sup> See Ghana's Companies Code 1963, s 40(1), which provides explicitly that: 'All shares created or issued after the commencement of this Code shall be shares of no-par value.' See also New Zealand Companies Act 1990, s 28, which provides expressly that: 'No share shall have a nominal or par value.'



especially, to the unsophisticated investor who is apt to think that he is getting a bargain if he buys a \$G1 share for 10 cents. And that he has been cheated if he is able to buy for 30 cents. If Ghanaians are to be encouraged to invest in shares everything should be done to make it clear to them that a share is simply a share in the fluctuating value of a business and not a piece of paper worth the value endorsed upon it.<sup>33</sup>

### **Arguments in Support of the No-Par Value System**

Generally, shares issued without par value afford a more realistic approach to appraisal of profits in relation to the assets employed in a business.<sup>34</sup> Such an approach avoids problems associated with determining profits and dividends by reference to a nominal value.<sup>35</sup> Also, the issue of shares of no-par value affords flexibility. The issuing company is free from threats pointing to prohibitions on share watering. Indeed, in a troubled economy, such as where there is war, companies may wish to issue shares at lower prices. They should be able to do so without a cloud of juridical fear distilling on them. At the same time, it must be acknowledged that it is in furtherance of good business practice that companies must be permitted to raise finance by selling shares at a fair and true value. If such a view is overlooked, companies may begin to engage in over-leverage to raise finance. Over-leverage could then increase the risks and costs associated with insolvency on both ends of the debtor and the creditor.

Countering the school of thought that supports the no-par value system, Berle argues that the concept of no-par value could be open to abuses by some company directors.<sup>36</sup> This view assumes somewhat that no remedial measures will be taken by the company because the legal system is not transparent enough for the shareholders to access the relevant information on the abuses.

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<sup>33</sup> See *Final Report Of Commission Of Enquiry Into Working And Administration Of Company Law Of Ghana*, supra, (n 1), p 53.

<sup>34</sup> See *Memorandum from The Council Of The Chartered Institute Of Secretaries Of Joint Stock Companies And Other Public Bodies To Gedge Committee*, op cit, p 7.

<sup>35</sup> See R Pennington, op cit, p 21.

<sup>36</sup> See generally A A Berle, op cit.

Indeed, Berle observes that in dealing with non par-value corporations having shares, an investor must ascertain whether shares without a visible dollar mark on the share certificate are in fact true non-par value shares, or whether they are 'stated value' non-par value shares – in substance merely a par value share with a different name.<sup>37</sup>

Adding to the criticisms, BonBright argues that the removal of par value is likely to lead to a serious danger in corporate finance, that is, the danger that stated capital will be fixed far below the real capital.<sup>38</sup> Basing his analysis on the Delaware Law of 1917, c133, and the New York Law of 1923, c787 s 12, BonBright observes that the law forces the drawing of the conclusion that creditors have been stripped of their long-recognised rights to hold shareholders liable for part-paid shares and to hold directors of the issuing company liable for an impairment of capital.<sup>39</sup> However, this view has its own limitations. Indeed, as was held in the US case of *American Co v Staples*,<sup>40</sup>

'it has been said that while non-par value stock corporations have no nominal value – no dollar mark – stated in the face of their stock certificates, yet the general rules regarding the liability of the subscribers for non-payment of the full amount of their subscription, and the general rules regarding the declaration of dividends, apply as in the case of par-value corporation, the liability of the shareholders depending upon whether he has paid or delivered, the amount in money, or its equivalent for the stock that non-par value was sold while the capital stock of a corporation cannot be lawfully invaded by the declaration of dividends any more than the capital stock of a par value stock corporation.'

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<sup>37</sup> See generally, *ibid*.

<sup>38</sup> J C BonBright, *op cit*, p 449.

<sup>39</sup> See *ibid*, p 449.

<sup>40</sup> 1924 Tex Civ App 260 S W 614.

## Conclusion

This paper has examined the policy issues underpinning the legal aspects of par value of company shares. The paper argued that the concept of par value has little relevance in the world of commerce today and that shares of no-par value often reflect the true value of the shares.

It has observed that whereas English company law still recognises the concept of par value as applicable to allotment of shares, the position in the US, Ghana, New Zealand and Canada show that the concept of par value is now obsolete and redundant. Indeed, the case of emerging markets would also support the redundancy of this concept. In many emerging markets there is an urgent need to overcome constraints such as inadequate liquidity. One of the ways of doing this is by permitting companies to issue shares of no-par value so that small investors can invest in these companies.

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## Editorial Comment

English Company Law is presently under review. In February 1999 the Company Law Review Steering Group produced a consultation document entitled *Modern Company Law for a Competitive Economy - The Strategic Framework*. One of the issues that is being explored is that of No-Par Value shares. The group believe that the requirement that shares should have a nominal value has become an anachronism (at para 5.4.27). However, there may be a difficulty arising from the EC company law Directives. While there is no formal requirement in these Directives for shares to have a nominal value, the second and fourth Directives require shares to have an 'accounting par value'. The second Directive also requires that NPV (no-par value) shares of public companies may not be issued below this 'accounting par value'. This means that as the requirement of the second Directive is at the moment, we could not introduce a complete NPV regime to cover all types of companies. It has been suggested that NPV shares could be available to private companies, who if they wished to go public could then convert their shares to an 'accounting par value'.