

# A Summary of the Law Governing the Acquisition of Shares in a Public Company

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## Introduction

Other than where shares in a public company are purchased on the markets of the Stock Exchange, the most likely method of acquiring shares in a listed or unlisted public company will be to purchase the securities in response to a company's advertisement for an offer of its shares. The advertisement for shares will normally be contained within a prospectus or listing particulars. The purpose of this article will be to summarise the legal rules applicable to the regulation of an issue of shares emanating from offers to subscribe which are contained within a prospectus or listing particulars.

## Listed Securities

Listed securities are those securities which have been admitted to listing on the London Stock Exchange. Prior to 1984, listing on the Stock Exchange was almost exclusively regulated by the Stock Exchange's own listing rules. In 1984, in addition to the Exchange's listing rules, three EC directives<sup>1</sup> were implemented in the form of the Stock Exchange (Listing) Regulations 1984. Part IV of the Financial Services Act 1986<sup>2</sup> sought to regulate offers of listed securities in compliance with the aforementioned EC directives.

Following the recent implementation of the Prospectus Directive<sup>3</sup> by the

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<sup>1</sup> The said directives were the Admissions Directive (No 79/279), the Listing Particulars Directive (No 80/390) and the Interim Reports Directive (No 82/121).

<sup>2</sup> Hereafter referred to as the FSA 1986

<sup>3</sup> (89/298)

Public Offers of Securities Regulations 1995<sup>4</sup>, Part IV FSA1986 has been subjected to technical alterations albeit that the nature of the alterations, in so far as they affect listed securities, do not form a substantive deviation from the regulatory effect of Part IV of the FSA 1986.

Basically, the 1995 Regulations provide a new and wider regime for the control of public offers of corporate securities offered within the UK and apply where securities are offered to the general public for the first time, irrespective of whether a listing is required. For the purposes of the 1995 Regulations, offers of securities include offers for a cash or a non-cash consideration. An advertisement to sell securities to the general public is deemed an offer to sell such securities, albeit that in contract law an advertisement for sale is normally regarded as an invitation to treat. Other than where the 1995 Regulations apply, the offer document may still be referred to as listing particulars. For example, an offer document will still be referred to as listing particulars where the offer is not a first offer of the relevant securities or where existing securities are introduced into the London Stock Exchange from the Unlisted Securities Market or Alternative Investment Market. The ultimate aim of the Prospectus Directive, as implemented into the UK by the 1995 Regulations, is to encourage the creation of a European market with common rules for the regulation of dealings in securities.

The Stock Exchange is responsible, in the case of an offer for listed securities, for vetting applications for the publication of a prospectus or listing particulars. Under s144(2) FSA 1986, as amended by the 1995 Regulations, prior to the publication of the prospectus or listing particulars the offer document must first be submitted in draft to the Stock Exchange for their formal approval. In circumstances where the Stock Exchange consider the application detrimental to the interests of investors, the application may be refused; although the Stock Exchange's decision may be subject to judicial review. In relation to an application for listing, s154 FSA 1986, gives the Stock Exchange the power to control the nature of advertisements in relation to the issue of a prospectus or listing particulars; the Stock Exchange must approve all such

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<sup>4</sup> SI 1995/1537, hereafter referred to as the 1995 Regulations.

advertisements.

## **Unlisted Securities**

In 1980, the London Stock Exchange created the unlisted securities market (the USM). This second market was established in an attempt to encourage the trading of securities in those public companies which were not sufficiently established to offer securities on the listed market. Initially, acceptance onto the unlisted market was more relaxed in terms of the procedural requirements which formed a prerequisite of entry onto the listed market. However, as a consequence of less stringent standards of admission into the principal markets of other EU countries, the lowering of standards for admission onto the listed market became an inevitable consequence of the London Stock Exchange's desire to remain competitive with other EU markets. As a result, the regulatory distinction between the listed and unlisted markets was significantly reduced to the point whereby it became almost redundant. As a consequence of the weakening of the distinction between the two markets, the unlisted securities market has been abolished, it has been replaced by the "Alternative Investment Market" (AIM.). This new market officially opened in June 1995 and will perform basically the same function as that originally perceived to have been undertaken by the USM.

Prior to the introduction of the 1995 Regulations, the statutory control of prospectuses for unlisted securities was left to provisions contained within the Companies Act 1985. Although the FSA 1986 had sought to consolidate the regulation of both listed and unlisted securities, Part V of the 1986 Act, which dealt with unlisted securities, was never brought into force. The principal reason for Part V's failure to attain statutory force was related to the UK's need to comply with the subsequent EC Prospectus Directive.

Public offers of unlisted securities are now regulated by the 1995 Regulations where the convertible securities,<sup>5</sup> which are the subject of a proposed issue, are to be offered to the general public for the first time. To

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<sup>5</sup> Convertible securities are defined by reg 3(1)(b), naturally the definition includes shares and debentures.

comply with the 1995 Regulations, the company issuing the securities must publish a prospectus which, during the duration of the offer, must be made available to the general public at a UK address; no charge must be levied for a copy of the prospectus.<sup>6</sup> In addition to including detailed disclosures about the issuer and the securities to be offered<sup>7</sup> the 1995 Regulations<sup>8</sup> provide, with the exception of pre-emptive issues<sup>9</sup> and issues previously made within the preceding twelve months,<sup>10</sup> that the issuer must include within the prospectus all such information which would enable investors to make an informed assessment of the issuer's assets, liabilities, profits and losses. Other than where the Stock Exchange considers the publication of certain information to be detrimental to the issuer,<sup>11</sup> the information must provide an account of the financial state and immediate prospects of the issuer and the specific rights to be attached to the securities which are to be the subject of the offer.

An offer of securities "for the first time" includes securities which are of the same class as securities that have previously been offered by the offeror to the public in the UK. However, where the number or value of the securities to be offered is less than 10% of the number or value of the securities already offered, and detailed and up-to-date information about that class of securities is available in accordance with the criteria provided by Sch 1 of the 1995 Regulations, then in such circumstances the need to issue a prospectus in respect of such securities is waived.<sup>12</sup>

The 1995 Regulations apply if the offer is for a cash or non cash

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<sup>6</sup> Reg 4(1)

<sup>7</sup> 1995 Regulations Sch1

<sup>8</sup> Reg 9(1)

<sup>9</sup> Reg 8(4)

<sup>10</sup> Reg 8(6)

<sup>11</sup> Reg 11(3)

<sup>12</sup> Reg 8(5)

consideration and are also applicable to a situation where the offer is made other than in writing. The scope of the 1995 Regulations extends to a situation whereby the shares are being offered other than by the issuing company. For example, the 1995 Regulations will apply to a shareholder or underwriter of an issue, albeit that the necessary disclosure requirements in relation to the issuing company will, as one might expect, be less severe than if the company itself was purporting to make the offer of the securities.<sup>13</sup>

### **Exceptions to the 1995 Regulations**

Offers of securities which are not governed by the 1995 Regulations are specifically provided for and such exceptions are applicable to both listed and unlisted securities.<sup>14</sup> Where applicable the exceptions deem that an offer of securities may be instigated without the production of a prospectus. The list of exceptions is extensive. Examples of the said exceptions include; offers made to no more than 50 persons, offers made to members of a club or association or other restricted circle of persons, offers of bonus shares, offers to the UK Government, offers the total consideration for which would not realise more than ECU 40,000 and securities offered in connection with a takeover offer or a merger as defined by the Merger Directive.<sup>15</sup>

### **Mutual recognition of prospectuses**

The 1995 Regulations have implemented the EU Prospectus Directive into UK law. As such, the 1995 Regulations give effect to the mutual recognition of prospectuses or listing particulars across the EU. Therefore, providing a prospectus or listing particulars have, in compliance with the Listing Particulars Directive, been vetted in the course of satisfying a member state's

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<sup>13</sup> Reg 11(2)

<sup>14</sup> Reg 7

<sup>15</sup> (78/855)

regulations, the securities which form the subject of the prospectus or listing particulars may be offered or admitted to listing in other member states. In accordance with s156A FSA 1986, and providing the UK is one of the member states in which the securities are to be offered, a prospectus relating to unlisted securities may be submitted to the London Stock Exchange for its approval in compliance with the mutual recognition provisions. The information to be contained in such a prospectus will, for vetting purposes, be governed by the Listing Rules and not the 1995 Regulations.

### **Rescission and Compensation for a false or misleading statement contained within a prospectus of listing particulars**

#### Rescission

Where a person acquires securities in a public or private company in reliance of a fraudulent, negligent or innocent misrepresentation (or omission) in relation to the offer of those securities proceedings may, if the offeree so desires, be taken to rescind the contract. A person may only exercise a right of rescission where that person was in a contractual relationship with the company for the purchase of the securities. In other cases, the right to rescind may be exercised against the offeror of the securities. Following rescission, the purchase price of the securities plus any interest will be returned to the offeree. A person's right to rescind the contract may be lost where the offeree, after becoming aware of the misrepresentation, acted in a manner to affirm the contract, where there was an unreasonable delay in seeking to rescind the contract, or where the issuing company has been placed into liquidation.

The rule of law established in the case of *Houldsworth v City of Glasgow Bank*<sup>16</sup>, namely, that any claim for damages against a company may only be sustained if the contract relating to the security issue had been rescinded, was

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<sup>16</sup> (1880) 5 App Cas 317

expressly overturned by s111A CA 1985.<sup>17</sup>

## Compensation

Compensation will be payable to a subscriber of shares where the damage or loss to the value of issued shares resulted from any untrue or misleading statement or omission contained within a prospectus or listing particulars which, in compliance with the relevant statutory provisions, should have been included within the prospectus or listing particulars.<sup>18</sup> It is important to note that an issuer's liability will not be dependent upon whether or not the subscriber relied upon the misstatement or had knowledge of any omission. Liability also extends to supplementary listing particulars and prospectuses.

## Defences

The defences available to an issuer of securities are available irrespective of whether the securities to be offered are listed or unlisted securities.<sup>19</sup> The list of defences is extensive and concentrates its attention on providing a means of evading liability where misstatements were innocently made. It is especially important to note that a person responsible for the offer document may escape liability where it is established that the subscriber was aware that the offending statement was indeed untrue or misleading or had knowledge that a matter which should have been included in the offer document had in fact been omitted. In effect, this defence re-introduces the requirement related to a subscriber's reliance on a misstatement. However, the crucial difference in the law as it now stands after the 1995 Regulations is that the burden of establishing

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<sup>17</sup> Inserted into the CA 1985 by CA 1989, s131(1).

<sup>18</sup> For unlisted securities see Reg 14. For listed securities see FSA 1986, s154A (introduced by 1995 Regulations, Sch 2(3) ). For listing particulars see FSA 1986, s150).

<sup>19</sup> The defences are listed in FSA 1986, s151 in respect of listing particulars or in FSA 1986 s154A (introduced by Sch2(3) 1995 Regulations) in the case of a prospectus required by the listing rules. For a prospectus issue in relation to unlisted securities the defences are listed in the 1995 Regulations, Reg 15.

reliance has been moved from the subscriber to the issuer.

### **The persons responsible for a prospectus or listing particulars**

The persons who are deemed responsible for the publication and contents of an offer document are defined in relation to listing particulars and listed securities advertised by a prospectus in accordance with the FSA 1986.<sup>20</sup> For the purposes of a prospectus issue of unlisted securities the relevant persons are defined by the 1995 Regulations.<sup>21</sup> The appropriate definitions also apply to the issue of a supplementary prospectus or supplementary listing particulars.

### **The statutory remedies and the calculation of damages**

As a consequence of the 1995 Regulations, the statutory remedy for an untrue or misleading statement contained within a prospectus offering unlisted securities is now aligned to the statutory remedy for an untrue or misleading statement contained within a prospectus or listing particulars offering listed securities. Prior to the 1995 Regulations, a prospectus offering unlisted securities was governed by s67 CA 1985. Under the aforementioned provision compensation was payable where any person who had subscribed for shares or debentures following the advertisement of such securities in a prospectus, suffered loss or damage as a consequence of having relied upon the contents of the prospectus where the said contents contained a misleading statement of a fraudulent or negligent character.

As the law now stands after the implementation of the 1995 Regulations, compensation is payable to any person who has suffered damage or loss as a result of acquiring securities which were advertised in the prospectus.

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<sup>20</sup> FSA 1986, s152 and FSA 1986, s154A (introduced by Sch2(3) 1995 Regulations) in relation to a prospectus for the advertisement of listed securities.

<sup>21</sup> Reg 13.

Accordingly, the class of persons to whom compensation is payable would appear wider than under s67 CA 1985, because under the 1995 Regulations the payment of compensation is not dependent upon a person having subscribed to the issue of securities; that is, it is no longer a pre-requisite to the ability to seek compensation for the purchaser of the securities to establish that the securities were purchased directly from the issuing company. Therefore, there would appear to be no specific requirement for the purchaser of the securities to have been in a contractual relationship with the issuing company. The absence of any contractual relationship extends the scope of the remedy beyond other statutory remedies which are concerned with the provision of compensation for false and misleading statements.<sup>22</sup>

As with s67 CA 1985, any compensation payable under the 1995 Regulations (and Part IV FSA 1986 ) is likely to be calculated on principles based upon the tort of deceit; ie by attempting to put the plaintiff back in the position he was in prior to the untrue or false statement, the tort measure of damages having been historically applied to the term "compensation".<sup>23</sup>

### **Ascertaining the true market value of shares**

In the assessment of a valuation figure for shares purchased as a result of a misrepresentation, the court will initially seek to predict the true market value of the share as of the date of purchase.<sup>24</sup> However, in arriving at a valuation figure the court must consider the nature of the misrepresentation and the inflationary effect it would have had on the market price of the share. Following the recent decision of the House of Lords in *Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd* <sup>25</sup> it would now appear

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<sup>22</sup> For example, see the Misrepresentation Act 1967.

<sup>23</sup> See eg, *Clark v Urquart* [1930] AC 28.

<sup>24</sup> See, *Davidson v Tulloch* (1860) 3 Macq 783.

<sup>25</sup> [1996] 4 All ER 769 overturning the decision of the Court of Appeal [1994] BCLC 212

permissible for the courts, in relation to a valuation procedure, to take account of events which occurred subsequent to the date of purchase. Indeed, it is certainly clear that the decision of the House of Lords extends a claim for consequential loss to circumstances where a misleading event occurred prior to the actual share purchase, an event which inflated the price of the shares at the date of their acquisition. Further, the ability to claim such consequential loss will exist irrespective of the fact that the offeror of the shares had been unaware of the said inflationary event.<sup>26</sup>

Prior to *Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management Ltd)* any reduction in the value of shares as from the date of their acquisition or an event which prior to the share purchase had artificially inflated the share price would have been ignored for the purpose of assessing damages. The strict adherence to this rule operated despite the fact that in assessing damages for the tort of deceit the courts would, in instances other than those concerned with the valuation of shares, award damages for any consequential loss which had flowed from an untrue statement, providing that loss was not too remote.<sup>27</sup>

### **Shares purchased following a non-contractual representation**

Where a purchaser is induced to acquire securities in a company, other than securities offered in a prospectus or listing particulars, following a misleading statement made by the company, then the purchaser will be unable to claim a statutory remedy against the company or its directors. For example, a purchaser may have been induced to purchase shares in a company on the open market as a result of having relied upon a misstatement contained within a prospectus.

However, a purchaser of such securities may be able to obtain a remedy

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<sup>26</sup> The *Smith New Court* case was concerned with a fraudulent misrepresentation but the determination of consequential loss in a case of negligent misrepresentation may be determined in a like manner to fraudulent misrepresentation, ie on the basis of the tort of deceit .

<sup>27</sup> See eg, *Naughton v O'Callaghan* [1990] 3 All ER 191 and *Royscot Trust Ltd v Rogerson* [1991] 3 All ER 294.

for the misstatement where it is possible to establish an action in deceit. Here it would be necessary to prove that as a direct result of a fraudulent misstatement the purchaser was induced to take the shares. Alternatively, the purchaser may commence an action based on a negligent misstatement, that is, where it is established that the company owed the purchaser a duty of care. In *Hedley Byrne Ltd v Heller Ltd*<sup>28</sup>, the House of Lords established the rule that a duty of care would arise in a situation where there was a "special relationship" between the parties so as to establish a sufficient degree of proximity between them. The relationship being established in a situation where the representee was shown in the circumstances of the case to have placed reasonable reliance upon the misstatement. However, in *Caparo Industries plc v Dickman*<sup>29</sup> the scope of the proximity test was subsequently reformulated by the House of Lords. The test has been reformulated to the extent that the representee's reliance on a misstatement should, in order to establish a "sufficiently approximate relationship", have been for a definite purpose, the purpose having been made known to the representor, who himself must have been aware that the misstatement would be relied upon by the representee. The effect of the reformulation of the test is to place a much more onerous burden on the representee in terms of establishing a negligent misstatement.<sup>30</sup>

## Conclusion

Prior to the introduction of the 1995 Regulations, the nature of the statutory control of a prospectus advertising an offer of securities was dependent upon whether the offer was for listed or unlisted securities. To a large extent the distinction between the rules relating to an offer of unlisted and listed

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<sup>28</sup> [1964] AC 465

<sup>29</sup> [1990] 2 AC 605

<sup>30</sup> See eg, *Al Nakib Investments (Jersey) Ltd v Longcroft* [1990] 3 All ER 330, but note the decision of Lightman J in *Possfund Custodian Trustee Ltd v Diamond* [1996] BCLC 665, a decision which appears to revert back to the "Hedley Byrne" principles.

securities has now been dispensed with in a situation where the securities are offered within the UK to the general public for the first time. The unification of the statutory control of prospectuses and listing particulars and the remedies available to subscribers to public share offers is to be welcomed as a sensible and logical marriage of rules which are applicable to an almost identical set of circumstances.

In respect of the rules governing the calculation of damages following a misrepresentation contained within a prospectus or listing particulars the inequity of the law's insistence upon the calculation of compensation as of the date of the acquisition of shares has been removed. However, the strict approach taken by the courts to an award of damages, following a purchaser's reliance upon a misstatement contained within a prospectus, is such that the proximity test applied to determine the liability of the issuer is too readily weighted in his favour.<sup>31</sup>

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<sup>31</sup> But note the decision of Lightman J in *Possfund Custodain Trustee v Diamond*, *ibid.*