# THE PROHIBITION ON COMPANIES FINANCING DEALINGS IN THEIR OWN SHARES; VOID OR ILLEGAL CONTRACTS?

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Ever since *Trevor* v. *Whitworth*[1] it has been illegal at common law, as it now is by statute,[2] for a company to deal in its own shares. That decision of course covers certain other prohibitions relating to reduction of capital[3] but in this article it is only intended to refer to the specific prohibition against companies dealing with or in their own shares and to deal specifically with the question of companies assisting financially in the purchase of their shares. The relevant statutory provision is s. 67 of the Victorian Companies Act 1961.[4] By sub-s. (1) the Act provides:

> Except as is otherwise expressly provided by this Act no company shall give, whether directly or indirectly and whether by means of a loan guarantee or the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company, or, where the company is a subsidiary, in its holding company or (except in the case of borrowing shares of a building society) in any way purchase deal in or lend money on its own shares.

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1 (1887) 12 App. Cas. 409 and see *Thornett* v. *Federal Commissioner of Taxation* (1938) 59 C.L.R. 787 where it was distinguished and *Kirby* v. *Wilkins* [1929] 2 Ch. 444 for an explanation by Romer J.

2 See *e.g.* ss. 17, 67 Uniform Companies Act. The reference throughout this article is either to the Uniform Companies Act, which is for our purposes uniform throughout Australia, or the Victorian Companies Act 1961.

3 See now s. 64 of the Uniform Companies Act.

4 We will limit our discussion to s. 67. Sec. 17 deals specifically with holding companies holding shares in their subsidiaries. See Wallace and Young, *Australian Company Law and Practice*, at 88-89.

Sub-s. 2 of that section sets out a number of exceptions to the general prohibition.[5] A contravention of s. 67 (1) is an offence against the Companies Act and renders the company and every officer of the company at fault liable to imprisonment for three months or a penalty of $1,000.[6]

Where a company has extended moneys or made a loan used for the purchase of shares in itself (in contravention of the section) two further questions arise. The first question has led to very different results in English and Australian courts.[7] Is the money advanced by the company to a shareholder or other person in contravention of the section recoverable by the company from that person? In other words, the courts have been asked to determine whether or not a contract which is entered into in breach of s. 67 is a voidable or an illegal contract. The Australian decisions depart significantly from the 'early' leading English decisions on this issue but recently two English decisions suggest an approach more akin to the Australian. However there is in the Australian decisions a rather startling inconsistency which has not been satisfactorily explained.[8] This inconsistency is explained below.

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5 These exceptions are:

(a) where the lending of money is part of the ordinary business of a company, the lending of money by the company in the ordinary course of its business;

(b) the provision by a company, in accordance with any scheme for the time being in force, of money for the purchase of or subscription for fully-paid shares in the company or its holding company, being a purchase or subscription by trustees of or for shares to be held by or for the benefit of employees of the company, including any director holding a salaried employment or office in the company; or

(c) the making by a company of loans to persons, other than directors, bona fide in the employment of the company or of a subsidiary of the company with a view to enabling those persons to purchase fully-paid shares in the company to be held by themselves by way of beneficial ownership.

An interesting example of a case which came within exemption (*b*) is *Hogg* v. *Cramphorn Ltd.* [1966] 3 All E.R. 420. See also *M. Dalley & Co. Pty. Ltd.* v. *Sims* (1968) 43 A.L.J.R. 19 at 23.

6 S. 67 (3).

7 See *Victor Battery Co. Ltd.* v. *Curry's Ltd.* [1946] Ch. 242; followed in *Curtis's Furnishing Stores Ltd.* v. *Freedman* [1966] 2 All E.R. 955. The Decision in *Freedman* has been described as having been distinguished implicitly by Cross J. (who had decided *Freedman*) in *South Western Mineral Water Co. Ltd.* v. *Ashmore* [1967] 2 All E.R. 953. Bretten, 'Financial Assistance in Share Transactions, (1968) 32 *Conv. & Prop. Lawyer* 6 but see discussion *infra*. *Victor Battery* was disapproved of in *Selangor United Rubber Estates Ltd.* v. *Cradock (No. 3)* [1968] 2 All E.R. 1073. In Australia *Victor Battery* was disapproved of and distinguished in *Dressy Frocks Pty. Ltd.* v. *Bock* (1951) 51 S.R. (N.S.W.) 390 which was 'followed' in *Shearer Transport Co. Pty. Ltd.* v. *McGrath* [1956] V.L.R. 316, *E. H. Dey Pty. Ltd.* v. *Dey* [1966] V. R. 464 and *Re Galpin, Ex parte Chowilla Timber Supply Co. Ltd.* (1967) 11 F.L.R. 155 and was approved by Ungoed-Thomas J. in *Selangor*. See also *Re International Vending Machines Pty. Ltd.* [1962] N.S.W.R. 1408, *Cooper* v. *Sandiford Investments Ltd.* [1967] T.R. 163, and *Shilling* v. *Garden Island Co. Pty. Ltd.* [1967] W.A.R. 147.

8 In both *McGrath* and *Dey* the court held that the moneys could be recovered and relied on *Dressy Frocks* to reach such a conclusion. As shall be noted later, this was specifically denied in *Dressy Frocks*.

It is unnecessary to examine in any detail the practical operation of the section.[9] It was probably introduced for a number of reasons.[10] The section is aimed at preventing injury to a company which by lending assets in respect of the purchase of its own shares is thereby reducing its asset backing; the section is also aimed at preventing the weakening of the company's structure by an indirect reduction of its capital.[11] In addition the section provides protection for creditors who must rely on the company's capital structure in the event of the company failing to meet it obligations.

An important issue whenever a particular type of dealing is to be struck down as being illegal, is whether the particular provision is aimed at protecting an identifiable class of persons, or whether it is simply regarded as a general prohibition which is required as a matter of public policy.[12] It may be argued, and indeed has been argued[13] that the particular section is only a protection for creditors, as shareholders may take appropriate action against the directors of the company who have breached the provision and who may have caused the company to suffer a loss. Certainly the shareholders may bring proceedings against directors at general law[14] or, once the company is placed into liquidation, may bring proceedings under s. 305 of the Companies Act.[15] However, the directors in many cases are men of straw and remedies granted against them will be of little practical use. Whether the section was intended as a protective device at all, and whether it was available to the shareholders (or the company) are questions which have led to differing results in the courts.

*The English Cases—prior to Selangor*

The first relevant case, in point of time, which has been the basis of the different approach taken by the English and Australian courts on the question of the 'legality' of the loan, is the decision of Roxburgh J. in *Victor Battery Co. Ltd.* v. *Curry's Ltd.*[16] The defendant company had agreed to lend a Mr. Jaina a sum of money. This sum (ten thousand pounds) was to be used by Jaina to purchase shares in

9 See Wallace and Young, *Australian Company Law and Practice* p. 255 *ff*; see also *Mudge* v. *Wolstenholme* [1965] V.R. 702.

10 See Bretten, 'Financial Assistance in Share Transactions,' (1968) 32 *Conv. & Prop. Lawyer* 6 at 7-8 and *Re V.C.M. Holdings Ltd.* [1942] Ch. 235 and Rich J. in *Durack* v. *West Australian Trustee Executor and Agency Co. Ltd.* (1944) 72 C.L.R. 189 at 202 and Williams J. at 219.

11 See *Dressy Frocks* (1951) 51 S.R. (N.S.W.) 390 at 400-402; *Re V.C.M. Holdings Ltd.* [1942] Ch. 235 and Greene Committee Report.

12 See Ungoed-Thomas J. in *Selangor,* at 1150-1151.

13 See Herron J. in *Dressy Frocks* at 402.

14 See *e.g. Trevor* v. *Whitworth* (1887) 12 App. Cas. 409 and Lindley L.J. in *Re Sharpe. Re Bennett, Masoni and General Life Assurance Co.* v. *Sharpe* [1892] 1 Ch. 154 at 165-166. The court may of course excuse the directors under s. 365—see *Re International Vending Machines Pty. Ltd.* [1962] N.S.W.R. 1408; affd. by Privy Council in *Steen* v. *Law* [1963] 3 W.L.R. 802.

15 This provision extends to actions brought not only by the liquidator but by a contributory or a creditor. Note, however, that in Victoria the provision has been replaced by one which applies in a great variety of cases—s. 367 B.

16 [1946] Ch. 242.

the plaintiff company from certain persons. He agreed with the defendant company that he would procure the issue by the plaintiff company, to a person nominated by the defendant company, of a debenture for the amount of his indebtedness to the defendant company. No moneys were in fact ever advanced by the plaintiff company to Jaina but the loan was made by the defendant company to him. Later, however, the relevant debenture was executed by the plaintiff company. The plaintiff company then issued a writ requesting a declaration that the debenture was void and of no effect, having been given in contravention of the English provision equivalent to s. 67 of the Uniform Companies Act.[17] It was not *ultra vires* the plantiff company to give the debenture.

Roxburgh J. found that, on the true construction of the relevant section, the security given by the plaintiff company was not invalidated or avoided by the provision and that therefore he could not make the declaration. He distinguished between providing security in order to obtain financial assistance and giving financial assistance by means of security, and that in this instance the former situation existed.[18] This was not specifically prohibited by the Act. He went on to suggest that if this view was incorrect then nevertheless the plaintiff company would still be unable to succeed as it would have to rely on the illegality of its own action to support its claim. He held that the parties would be in *in pari delicto*.[19] The effect of his decision was to take away from the plaintiff company any rights of recovery in a situation where the relevant statutory provision had been breached.

His decision has been the subject of consistent criticism by Australian courts and more recently by English courts. However, it did receive a good deal of support in England prior to the most recent attack by Ungoed-Thomas J. in the case of *Selangor United Rubber Estates Limited* v. *Cradock*.[20] Cross J. in *Curtis' Furnishing Stores Ltd.* v. *Freedman* [21] reasserted the proposition that where there is a breach of the equivalent of s. 67 this results only in criminal liability on the part of the company and the directors and in no way invalidates the transaction. In such a case there can be no right of recovery by the company.

Freedman owed the company £22,000. He was a director of the company and held all but 102 shares of its issued capital. The company itself was in debt to trade creditors in the sum of £17,500. Because of this disadvantageous trading picture arrangements were made for certain persons who would thus obtain tax advantages to buy out Freedman's shares in the company. The agreement was

17 *I.e.* s. 54 of the English Companies Act referred to hereafter as 'U.K. s. 54.'
18 [1946] Ch. 242 at 247-248.
19 *Ibid.*, at 249.
20 [1968] 2 All E.R. 1073.
21 [1966] 2 All E.R. 955.

for Freedman's shares to be purchased for £1. At the same time the purchasers agreed to obtain the release of Mr. Freedman from his indebtedness to the company. Not long afterwards the company went into liquidation and the liquidator brought proceedings against Freedman under the equivalent of s. 305 of the Uniform Companies Act (the misfeasance provision) alleging amongst other things that Freedman had breached U.K. s. 54, (*i.e.* s. 67 of the Uniform Companies Act). No references were made by Cross J. to various Australian cases[22] which had been decided and which had distinguished and disapproved of the holding of Roxburgh J. in the *Victor Battery* case. Cross J. held that the release obtained by the purchasers was valid and that the liquidators could not recover from Mr. Freedman the sums which the company had virtually lost as a result of this release. It is interesting to examine the language used to justify this conclusion.[23]

> As regards section 54, the defendant pointed out that the infringement occurred not when the agreement was entered into but later when the company—under the control of Meyer and Joseph—released the debt and I must take it that it did. It was further pointed out that the decision of Roxburgh J. in *Victor Battery Company Ltd.* v. *Curry's Ltd.* shows that, although the section makes the company guilty of a criminal offence, it does not invalidate the disposition—in this case the release—which the company had made.

It has been suggested[24] that Cross J. has changed his approach to this problem in a later case, *South Western Mineral Water Co. Ltd.* v. *Ashmore.*[25] Unfortunately the report does not indicate to what extent Cross J. considered his earlier opinion in *Freedman's* case nor to what extent he considered the decision in *Victor Battery* case. One finds the reported decision in the *Ashmore* case unsatisfactory for this reason.

The controlling shareholder of the M. Co. Ltd. having died, Ashmore agreed to purchase the assets of the company. The purchase was to be on terms. Ashmore, not intending to run the business in his own name, arranged to purchase the issued shares of S. Ltd. a wholly owned subsidiary of M. Ltd. He was given an option to purchase these shares at a price which represented the balance owing on the purchase of the M. Co. assets. This sum was to be secured by a debenture granted by S. Ltd. to M. Co. The M. Co. sued for the sum alleging the arrangements were in breach of U.K. s. 54; alternatively it claimed rescission of the agreement. Cross J. held that the agreement was not

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22 All the cases listed in n. 7, except *Dey* and *Galpin,* had been decided and reported by 1966.

23 [1966] 2 All E.R. 955 at 960.

24 Bretten, 'Financial Assistance in Share Transactions,' (1968) 32 *Conv. & Prop. Lawyer* 6, at 16-17.

25 [1967] 2 All E.R. 953.

null and void[26] and, indeed, he added that the fact that the granting of the debenture was in contravention of the Act did not mean that nobody could rely on the provisions of the agreement. 'No case that has been cited to me suggests that I am obliged to arrive at so ridiculous a conclusion.'[27] Cross J. held that the agreement could not be varied by demanding immediate payment and he suggested that each party should request *restitutio in integrum*[28] The decision does not it is suggested mark any departure from his thinking in *Freedman's* case where again he held that the arrangement was not null and void.[29] This would have been most unfortunate but as pointed out earlier there is a more recent decision in *Selangor United Rubber Estates Limited* v. *Cradock*[30] which adopts the line taken by the Australian courts on the question of the 'standing' of the contract entered into in breach of the relevant section.

*The Australian Cases.*

The reasoning adopted by Roxburgh J. in the *Victor Battery* case was based on the presumption that as the company was *in pari delicto* it could not plead the illegal contract and ask for it to be set aside. The Full Court of the Supreme Court of New South Wales in *Dressy Frocks Pty. Ltd.* v. *Bock*[31] discussed in some detail this notion of illegality and the application of it to the relevant provision in the Companies Act. This decision is believed to be on the one hand, *viz.* the 'standing' of the contract and the right of the company to repudiate it, the foundation of later developments culminating in the recent decision in *Selangor*. On the other hand, *viz.* whether the company, could recover money paid pursuant to the contract, the Court's decision in *Dressy Frocks* has been wrongly applied to reach some commercially satisfactory results.[32]

Dressy Frocks Pty. Ltd., a company incorporated in New South Wales, sued to recover moneys which it alleged were owing to it by Bock. The claim was in the form of an ordinary money count and the defendant pleaded that the plaintiff company was aware that the alleged debt was contracted by the defendant, and that he, Bock, would use the moneys lent to him to purchase from a shareholder in the company his shares in it. It was claimed by the defendant that there was a loan to the defendant for this particular purpose, and that as this was illegal under the terms of s. 148(1) of the Companies Act 1936 (N.S.W.) (equivalent to s. 67 of the current uniform legislation), the plaintiff was barred, on the basis that it was *in pari delicto*, from recovering loan moneys. The plaintiff demurred to this claim in the

26 *Ibid.*, at p. 958.
27 *Id.* The case of *Victor Battery* was cited in argument.
28 *Ibid.*, at 958, 960.
29 Bretten, 'Financial Assistance in Share Transactions,' (1968) 32 *Conv. & Prop. Lawyer* 6, at 16-17.
30 [1968] 2 All E.R. 1073.
31 (1951) 51 S.R. (N.S.W.) 390.
32 In *McGrath's* case and *Dey's* case—see *infra.*

defence. It was on this question that the case came on appeal to the Full Court of the New South Wales Supreme Court.

The Court canvassed quite fully[33] the earlier English decisions, especially the *Victor Battery Co.* case, and also examined the applicability of the relevant principle—*i.e.* that where a contract was illegal and parties are *in pari delicto* the court will not permit either party to enforce rights flowing from the particular contract in the particular situation.[34]

Street C.J. relied on a long line of authority commencing with Lord Mansfield's statement in *Holman* v. *Johnson,*[35] where his Lordship held that 'no court will lend its aid to a man who founds his cause of action upon an . . . illegal act,'[36] whilst Herron J. began his survey with *Harse* v. *Pearl Life Assurance Co.*[37] and both held that s. 148 of the N.S.W. Companies Act of 1936 (equivalent to s. 67) invalidated a contract carried out in contravention of the section. The principle enunciated by Lord Mansfield and Collins M.R. in *Harse's* case and applied in later cases[38] would, they said, be strictly applied by the Court.

The Full Court agreed[39] that the primary decision of Roxburgh J. in the *Victor Battery Co.* case was a difficult one to support on the facts. Nevertheless they were able to agree with, and rely on, his alternative conclusion that if the giving of the debenture in that case was to be regarded as an illegal act, in breach of the relevant section, the plaintiff company could not recover since it would have to rely on the illegality to support its claim. The parties in that particular case would have been *in pari delicto.*

Herron J. in the N.S.W. court also considered the question of whether the relevant section was inserted in the Act to protect companies or creditors.[40] The reason for the insertion into the Companies legislation of sections such as s. 67 may be traced as far back to the decision in *Trevor* v. *Whitworth.*[41] Lord Greene M.R. in *Re V.G.M. Holdings Ltd.*[42] enunciated reasons which are generally agreed to as the relevant factors influencing the insertion of the predecessor to s. 67:

> Those whose memories enabled them to record what had been happening after the last war for several years, will remember that a very common form of transaction in connection with companies was one by which persons—call them financiers, speculators, or

33 Street C.J. at 394-395; Owen J. at 396 and Herron J. at 400-402.
34 Street C.J., at 393-394; Herron J., at 397-400.
35 (1775) 1 Cowp. 341.
36 *Ibid.,* at 343.
37 [1904] 1 K. B. 558 at 563.
38 *E.g. Roach* v. *Beckle* (1915) 20 C.L.R. 663; see *Dressy Frocks Pty. Ltd.* v. *Bock* (1951) 51 S.R. (N.S.W.) 390 at 393-394; 397-400.
S.R. (N.S.W.) 390 at 393-394; 397-400.
39 Street C.J., at 395; Owen J., at 396; Herron J., at 401-402.
40 (1951) 51 S.R. (N.S.W.) 390 at 400 and at 402.
41 (1887) 12 App. Cas. 409.
42 [1942] Ch. 235.

> what you will—finding a company with a substantial cash balance or easily realisable assets such as war loans, bought up the whole or the greater part of the shares of the company for cash and so arranged matters that the purchase money which they then became bound to provide was advanced to them by the company whose shares they were acquiring, either out of its cash balance, or by the realisation of its liquid investments. That type of transaction was a common one, and it gave rise to great dissatisfaction and, in some cases, great scandals.[43]

On a wider approach it is clear that the basic philosophy which this particular section manifests is that where a limited liability company is created, its capital should not be disbursed on illegal or ultra vires activities to the detriment of the creditors.[44] Nearly all the judgments of their Lordships in *Trevor* v. *Whitworth*[45] spelt this out as the basis for the rule that a company must not deal in its own shares. For example, Lord Watson stated that one of the main objects contemplated by the legislature in restricting the power of companies to reduce the amount of their capital

> is to protect the interests of the outside public who may become [the company's] creditors. . . . Persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid to the coffers of the company has been subsequently paid out, except in the legitimate course of its business.[46]

Herron J., in the *Dressy Frocks* case, suggested he agreed with Roxburgh J. that the company did not come within the definition of a class of persons for whose protection the section was introduced.[47] This is obviously a very narrow reading of the protection that was intended. It would be hoped that had the attention of the House of Lords in *Trevor* v. *Whitworth*[48] not only been directed at the interests of creditors, but also the shareholders, the Law Lords would have reached an obvious conclusion: that it was in the shareholders' interest as well as in the creditors' interest to maintain the capital fund of the company and to ensure that it was not expended on illegal purposes.

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43 *Ibid.*, at 239.

44 See *e.g. Rowell* v. *John Rowell & Sons Ltd.* [1912] 2 Ch. 609; *Kirby* v. *Wilkins* [1929] 2 Ch. 444 and see Wallace and Young, *op. cit.* pp. 255-258.

45 (1887) 12 App. Cas. 409; see Lord Herschell at 415; Lord Macnaghten at 432-434.

46 (1887) 12 App. Cas. 409 at 423-424.

47 (1951) 51 S.R. (N.S.W.) 390 at 402.

48 (1887) 12 App. Cas. 409.

This view is not clearly enunciated in any of the cases relating to reduction of capital.[49] As reduction of capital was always treated as an *ultra vires* action (quite incorrectly),[50] it is suggested that on a clear understanding of the *ultra vires* doctrine[51] it is not difficult to spell out an intention to protect shareholders.[52] The *ultra vires* doctrine was 'introduced' for the protection of shareholders (and creditors).[53] So if a company was to be prevented from expending moneys on activities not within its objects, (which had been a basis of the contract[54] between members (and creditors)[55] and the company, why should it not also be said that the prohibition against the lending of moneys for the purchase of shares in the company is for the protection of shareholders? They are equally concerned to maintain the company's capital fund.

Where a company seeks to recover moneys, paid out under a contract made illegal by s. 67, it is clear that those to benefit from the recovery of these moneys will be not only the creditors of the company, but the shareholders, who may never have been aware of the illegal contract[56] and whose remedy against the directors may be completely ineffectual.

As pointed out earlier, the Full Court in the *Dressy Frocks* case held that the section made all contracts in breach of it illegal. The Court (or rather Herron J.) did not find any evidence of shareholders belonging to a class of persons whose protection was an aim of s. 67. The court upheld the defendant's allegation and struck out the declaration of the plaintiff company.

Despite the quite clear statement of principle in *Dressy Frocks*, O'Bryan J. held, in the Victorian case of *Shearer Transport Co. Pty. Ltd.* v. *McGrath*,[57] that a loan which had been made by a company to one of its members in contravention of the equivalent of s. 67, whilst void for illegality, was nevertheless recoverable at the suit of the company. His Honour fully endorsed the decision in *Dressy Frocks Pty. Ltd.* v. *Bock*,[58] but distinguished the case on the facts before him.

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49 See in particular *Australasian Oil Exploration Ltd.* v. *Lachberg* (1959) 101 C.L.R. 119. Note the very broad terms of the court's discretion under s. 64 of the Uniform Companies Act—it must consider the interests of shareholders as well as creditors—see *In the Matter of Fowlers Vacola Manufacturing Co. Ltd.* [1966] V.R. 97.

50 See *Flitcroft's* case ((1882) 21 Ch. D. 519) and Gower, *Principles of Modern Company Law* (2nd ed.) at 82.

51 Now limited by s. 20; and indirectly by s. 19 of the Uniform Companies Act.

52 See *Ashbury Carriage Co. Ltd.* v. *Riche* (1875) L.R. 7 H.L. 653.

53 But *contra* Fullagar J. in *Re K. L. Tractors Ltd. (In Liquidation)* (1960-1961) 106 C.L.R. 318 at 337 where he suggested only corporators are protected.

54 *I.e.* the Memorandum and Articles of Association; see Gower, *op. cit.* p. 141 *ff.*

55 The creditors are deemed to have notice of the contents of the company's public documents; see Gower *op. cit.* p. 141 *ff.*

56 As occurred in *Selangor's* case; see *infra.*

57 [1956] V.L.R. 316.

58 (1951) 51 S.R. (N.S.W.) 390.

Shearer Transport Co. Pty. Ltd. contained no power in its memorandum of association to make payments to directors unless consideration was advanced in return of the payment. In these circumstances O'Bryan J. stated:[59] 'Therefore, in my opinion, the payment was not only made without consideration, but it was made *ultra vires* the company.' Being *ultra vires* the company, the amount was recoverable. With respect to His Honour this is rather a strange if not untenable conclusion. Even if the company's memorandum of association had contained such a clause, *i.e.* permitting a loan to be made to McGrath to purchase shares in the company, such a power would have been illegal (not *ultra vires*) and, therefore, any loan made by the company would, by virtue of the equivalent of s. 67, have been struck down. It is clear that His Honour was troubled by the fact that such a reading would have prevented the company from recovering the moneys. He was concerned to ensure the protection of its capital fund.[60] He also held that the particular term would have been severable as had been the solution in *Spink (Bournemouth) Ltd.* v. *Spink.*[61]

Nevertheless, this particular decision was approved and followed in a later Victorian case of *E. H. Dey Pty. Ltd.* v. *Dey.*[62] Edward Dey was a director of the company which alleged that certain moneys were due for the sale of assets to Mr. Dey. In his defence to the action for damages in breach of contract, Dey claimed that his liability to the company had been discharged because of the deed made between two prospective shareholders of the company (S. N. Paul and J. E. Paul) of the one part, and himself and three other shareholders of the company of the other part, whereby the Pauls were to purchase his shares in the company for a specific price. The deed, it was alleged, further provided that the sum due from Dey to the company, in respect of the assets sold, were to be deemed to have been paid to the company, and that the purchase price for the shares should be reduced by the amount of the sum due under the contract for the sale of assets to Dey. It was further alleged that the deed and the matters in the deed were agreed to by all of the directors and/or shareholders of the company on or about the same day as the particular deed was entered into. At the trial the plaintiff company was allowed to amend its pleadings to include a plea that the particular sale of shares was void and illegal by virtue of the equivalent to s. 67 of the Companies Act.

Dealing with the question of the illegality of the particular arrangement McInerney J. distinguished the decision of *Victor Battery* and preferred the decision of O'Bryan J. and the New South Wales Full Court in *Dressy Frocks.* In such a situation he was prepared to

59 [1956] V.L.R. 316 at 318.
60 See Bretten, 'Financial Assistance in Share Transactions,' (1968) 32 *Conv. & Prop. Lawyer* 6 at 14-15.
61 [1936] Ch. 544; referred to [1956] V.L.R. at 318.
62 [1966] V.R. 464.

allow the company to recover the amount owing to it on the basis that any financial assistance given by it pursuant to an agreement to release the debt owed, in the manner alleged, would have been struck down by the relevant section.

His decision, however, turned on a number of different arguments. He was prepared to admit that the resolution by the company in general meeting to release Mr. Dey from his debt constituted an agreement supported by valuable consideration but that as this agreement was illegal the company could recover any benefit that flowed under it.[63] He did not allude to the clear denial by the court in *Dressy Frocks* of any right of recoverability by a company or assisted party under any such contract. Furthermore his Honour did not consider the fact that the decision in *McGrath's* case was based on the finding that there was no consideration for the loan—a fact which prompted O'Bryan J. to hold that the particular transaction was *ultra vires,* thus permitting the company to recover. McInerney J. did mention the question of severability raised in the English cases, such as *Spink (Bournemouth) Ltd.* v. *Spink,*[64] which may have assisted him in reaching his final decision but, as the particular matter had not been argued before him, he refrained from reaching any conclusion on it.[65] Once again, this decision, like many decisions in this area, is unsatisfactory.

The latest important Australian decision is that of Gibbs J. in *Re Galpin.*[66] A written agreement had been entered into between Galpin, Lee (Chairman of Directors of Chowilla Timber Supply Co. Ltd.) and the company whereby Galpin and Lee agreed to sell to the company certain assets (including saw mills) connected with the business of sawmilling and sleeper cutting. Galpin was to receive the sum of £5,000 payable in cash and was to be issued with 7,000 one pound ordinary shares in the company to be credited as fully paid. The money was not paid but the shares were allotted. By a later oral agreement between Galpin and the company the written agreement was varied so that Galpin was to receive £6,000 instead of £5,000 and was to retain one of the saw mills which had been the subject of the first agreement. Later a new written agreement was made between Galpin and the company whereby the company agreed to sell back to Galpin certain plant and machinery which had been part of the assets agreed to be sold in the first agreement. A second oral agreement was entered into between Galpin and the company whereupon Galpin was to be released from his obligations under the earlier agreements provided he signed transfers of the 7,000 shares issued to him. There was some disagreement as to the exact nature of this last agreement but the terms of the

63 *Ibid.,* at 468.
64 [1936] Ch. 544.
65 [1966] V.R. 464 at 470.
66 (1967) 11 F.L.R. 155.

agreement as stated above were the ones which his Honour was prepared to accept as representing the agreement.

It was submitted on behalf of the company that the second oral agreement was contrary to s. 67 of the Companies Act and was therefore illegal and void. Under these circumstances the company was entitled to recover from Galpin the moneys owed under the second written agreement. Gibbs J. held that the transaction as evidenced by that agreement was in effect a purchase by the company of its own shares—a slightly different approach to that alleged by the company.[67] Gibbs J. in the course of judgment, even though he admitted that it was not strictly essential for him to discuss this matter, supported the 'Australian' line of authority in holding that a contract in breach of s. 67 was void and of no effect.[68] He did not discuss whether recovery under such a contract would be permitted. He referred briefly to the decision in *Curtis Furnishing Stores Ltd.* v. *Freedman*,[69] but found the particular fact situation in that case sufficiently different to ignore the case.[70] The effect of his decision merely ensured that the earlier written agreements were the basis upon which the company was able to claim that Galpin owed it a debt and was thus able to petition for his bankruptcy.

The most lucid discussion of this area of the law, apart from that by the Full Court in *Dressy Frocks Ltd.*, is the relevant portion of the decision in *Selangor United Rubber Estates Ltd.* v. *Cradock*.[71] This decision covers a wide variety of subjects one of which was the question of financial assistance. We find the analysis by Ungoed-Thomas J. of this particular area of the law helpful. The relevant facts of this very complicated case are taken almost directly from the judgment of Ungoed-Thomas J.[72]

The plaintiff company (Selangor United Rubber Estates Ltd.—referred to as 'Selangor') was a company without a business in 1957-58 but with substantial liquid assets of about £235,800. Contanglo (a company experienced in takeovers) acting for an undisclosed principal, who was Mr. Cradock, made an offer for the stock in Selangor and the offer was accepted by about seventy-nine per cent of the stockholders. The total amount payable for the stock was about £195,000. Mr. Cradock had a bank account at a branch of the District Bank (referred to as 'District'). It was arranged that Selangor's £232,500 credit in its bank account with National Bank Ltd. (referred to as 'National') should be transferred to a new account in Selangor's name at the same branch of District. At a board meeting on 25 April 1958, a banker's

67 *Ibid.* at 159.
68 *Ibid.*, at 161-162.
69 [1966] 2 All E.R. 955.
70 11 F.L.R. at 162.
71 [1968] 2 All E.R. 1073.
72 [1968] 2 All E.R. at 1084-1089.

draft for the £195,000 on District in favour of Contanglo was transferred to Contanglo. In accordance with an arrangement between Mr. Cradock and District, this amount was to be debited to his account with District, and the payment was to be covered by a National draft for £232,500 by National for payment into Mr. Cradock's account. However, National, through a representative of District, transferred drafts for a total of £232,674 into Selangor's new account with District. In accordance with a resolution of Selangor's board to lend £232,500 to another company, Woodstock, a cheque for £232,000 was drawn on Selangor's new account with District in favour of Woodstock; and in accordance with an arrangement that Woodstock should lend that amount to Mr. Cradock, the cheque was endorsed by Woodstock in favour of Mr. Cradock, handed to District's representative, and paid into Mr. Cradock's account with District. The £232,000 covered the payment of the £195,000 to Contanglo (for the seventy-nine per cent, of the stock in the plaintiff company, bought by Contanglo for Mr. Cradock). Thus, Mr. Cradock obtained the stock, Contanglo the £195,000 paid for the stock (plus expenses and its own fee), Woodstock a liability for £232,500 from Mr. Cradock (at a one per cent higher interest rate), and Selangor, instead of £232,500 cash, obtained an unsecured liability on the part of Woodstock for that amount at eight per cent interest. Mr. Cradock's stock in Selangor was transferred to G. & C. Finance Ltd. as nominee for Mr. Cradock. On 24 February 1959, G. & C. Finance Ltd. was registered as holder of the stock and was issued the stock certificate. On 26 August 1958 Selangor's account at District was transferred to the Nova Scotia Bank. In January 1960, Mr. Cradock entered into a contract to sell his stockholding in Selangor. There were two meetings of Selangor's board on 26 January. It was resolved that the indebtedness of Woodstock to Selangor, *inter alia,* should be taken over, as to £207,500 by Mr. Cradock, and as the balance of the indebtedness by another company. It was also resolved that a cheque for £207,500 in settlement of Cradock's liability be handed by the purchaser of Mr. Cradock's shares for payment into Selangor's account.

No representative of Woodstock was present when the resolution about taking over Woodstock's liability was passed. On 27 January there was an exchange of cheques for £245,761.12s. each between Mr. Cradock and Woodstock and they passed through Martins Bank where Woodstock and apparently Mr. Cradock had accounts. This sum, it was said, represented the £232,500, plus outstanding interest, and Woodstock wrote to Mr. Cradock on 27 January 1960 that they had that day 'repaid you £242,671.12s. being a principal and part interest on a sum of £232,500.' Woodstock and Mr. Cradock were intending by this to eliminate Mr. Cradock's liability to Woodstock and that he should be liable, in Woodstock's place, to the plaintiff company. The effect of these transactions was that Selangor was financing Cradock's purchase (through Contanglo) of the seventy nine per cent interest in

Selangor. This is of course prohibited under s. 54 of the Companies Act 1948 [Eng.].

Ungoed-Thomas J. went back in time to cases such as *Holman* v. *Johnson*[73] to confirm that the courts would not be instruments for aiding illegality. The company, however, argued that the prohibition by U.K. s. 54 meant only that the courts would not assist in enforcing a contract or consensual arrangement in breach of this section and that this refusal to assist was limited to such cases and did not extend in particular to claims based on breach of trust. Ungoed-Thomas J. confirmed that the courts would not aid illegality but doubted that this was a matter that could be limited as suggesed:[74]

> The principle governing such consequences of illegality (namely the courts will not assist in enforcing an illegal contract) is not, however, just a twig of any particular branch of the law, but is rooted deeply in public policy—that the courts are not to be instruments for aiding illegality. The policy is not that the courts are not to be instruments for aiding illegality of contract, but may be instruments for aiding illegality in other branches of the law. It is in accordance with this substantial public policy nature of the court's refusal of aid to illegality that such illegality is not treated as a matter of pleading, or a matter merely as between the parties, but as a matter of which the court will, of its own initiative, take cognizance irrespective of pleadings or wishes of the parties. The objection to aiding illegality is thus not limited in its origin in public policy to any particular form of action.

His Lordship then considered the decision in *Boissevain* v. *Weil*,[75] where Lord Radcliffe stated that the courts did not consider that an illegal act could be the source of civil rights in the courts of England. He felt that Lord Radcliffe intended the wide meaning which his words bore. This precluded any argument that a specific 'narrow exception' might be made if the illegality did not arise either in contract or pursuant to 'consensual arrangements.'

This however did not affect the suggestion that where a breach of trust occurred such breach might be pleaded as the basis of recovery even though the breach amounted to an illegality. In *Steen* v. *Law*[76] the liquidator of a company claimed that directors, in giving financial assistance, had breached the equivalent of s. 67 and that they had also committed a breach of their duty owed to the company and should reimburse the company the sums which had been illegally applied by them. The Privy Council did not consider the question of whether the particular financial assistance was illegal and whether this illegality stood in the way of any claim for recovery:

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73 (1775) 1 Cowp. 341.
74 [1968] 2 All E.R. at 1150.
75 [1950] A.C. 327.
76 [1963] 3 All E.R. 770, affirming Jacobs J.

> [A]nd it seems to me for a very good reason that the company was not relying for its claim on the unlawful loan and the relationship of creditor and debtor thereby created, but upon the misapplication by the directors of the company's monies by way of the unlawful loan.[77]

It was such a situation that Ungoed-Thomas J. suggested existed in the *Selangor* case. He considered that the courts in such a case were not being invited to aid illegality, but to condemn it. However, in the instant case the company did not rely on the transaction as the source of civil rights because the transaction was illegal. The company's claim, whether it be brought by it or by its liquidator, was based on a breach of trust. The company was not a party to the particular transaction. It was not placing any reliance upon any right which the transaction may have conferred. It was claiming 'recovery'

> against the directors and constructive trustees for perpetrating that transaction and making the plaintiff company party to it in breach of trust owing to the plaintiff company. The breach of trust includes the making of the plaintiff company a party to the illegal transaction. So it seems to me clear on analysis that the plaintiff company is not precluded from relying on breach of trust by a party to an illegal transaction, to which the plaintiff itself is a party, when the breach includes the making of the plaintiff company a party to that very transaction.[78]

The result in the *Selangor* case was that the plaintiff company could not, by reason of the alleged illegality of the 'loan,' be prevented from being reimbursed money paid by it under a transaction to which it was a party.

Ungoed-Thomas J. confirmed the suggestion made in *Dressy Frocks Pty. Ltd.* v. *Bock* that the company was not a person for whose protection s. 67 had been passed.[79] He referred to an unreported decision, *viz. Essex Aero Ltd.* v. *Cross*[80] in which the English Court of Appeal reached a similar conclusion. It should be finally noted in connection with this decision that Ungoed-Thomas J. criticised the decision in *Victor Battery* case concluding that Roxburgh J. had reached the wrong result on the facts before him.[81]

One finds the decision in the *Selangor* case a satisfactory one on the question of the 'standing' of the contract. It clearly supports the reasoning of the New South Wales Full Court in the *Dressy Frocks* case. However his Lordship does not in any way suggest that some of the statements in the later Australian cases may well be misleading.[82] On the other hand, the decision is an unfortunate one, in that it

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77 [1968] 2 All E.R. at 1151.
78 *Ibid.*, at 1152.
79 *Ibid.*, at 1153.
80 Nov. 1961; see [1968] 2 All E.R. at 1153.
81 [1968] 2 All E.R. at 1154.
82 He refers to *Dey* but not to the question discussed above.

reinforces the view that the contract of loan entered into in breach of s. 67 will be illegal and that the company will be unable to recover moneys advanced pursuant to it unless it can sue for breach of trust. In this regard, the decisions or rather the result in the two Victorian cases may, as a matter of commercial reality, be preferred. One finds it difficult to deny the merits of these results on the basis that recovery would ensure the protection of the capital fund. This fund it is suggested should be protected not only for creditors, but for the company. The basis of recovery in the *Selangor* case may not always be appropriate. The directors were being sued on the basis that they had acted in breach of trust. But in some instances the moneys may have been dissipated to a third party, or the directors who may be men of straw; or it may be difficult if not impossible to spell out a breach of trust—although one could argue that a breach of a specific statutory provision is a breach of trust. The Jenkins' Committee has specifically recommended a right of recovery by the company—but it has also suggested sweeping changes to the provision. Until this change is introduced, the application of the section will be an interesting exercise for the courts. It is hoped that some attempt will be made to reconcile, if possible, the direct 'conflict' between *Dressy Frocks* and the later cases.

*An Addendum: The Jenkins' Committee Recommendation.*

The Jenkins' Committee found that the section was 'drawn in terms so wide and general that it appears to penalise a number of innocent transactions.'[83] It considered at length[84] various defects in the legislation and recommended substantial changes to the section. Financial assistance was to be possible if such assistance was approved by a special resolution of the company[85] and if the company filed a declaration of solvency[86] (to protect creditors). The holder of ten per cent of the dissenting minority was to have the right to apply to the court to prohibit the transaction (within twenty eight days).[87] In addition the committee recommended that transactions in breach of the new section were to be voidable at the instance of the company against any person 'who had notice of the facts.'[88] Penalties for breach were to lie against the directors but not the company.[89]

Recovery however will be extremely difficult. How will the company prove that a party had notice of the facts? Inspection at the Companies Registry is tedious enough as it is without imposing a further obligation. On what grounds will a court upset a loan? What if the declaration of solvency is fraudulent or misleading? What if the fund of the company has been watered down?

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83 Report of the Company Law Committee, Cmnd. 1749/1962 para. 171.
84 *Ibid.*, paras. 175-176.
85 *Ibid.*, paras. 187 (d)(i).
86 *Ibid.*, paras. 179, 187 (d)(i).
87 *Ibid.*, paras. 187 (d)(ii).
88 *Ibid.*, paras. 187 (d)(viii).
89 *Ibid.*, paras. 187 (d)(v).

Whilst some of these recommendations merit careful consideration, the prime purpose of the section is to protect the fund. Why should not creditors be given a right to contest the giving of assistance? They are protected on a reduction of capital even though they have no right to oppose the reduction.

The blanket prohibition has been criticised and we would agree that it should go. However the terms of the recommendations are not in our opinion completely acceptable.