THE RIGHTS OF PREFERENCE SHAREHOLDERS—REALITY OR MIRAGE?*

Professor Gower in the second edition of his work on the principles of Company Law enunciated a number of canons of construction which, he urged, summarise the "position" of preference shareholders in certain specific situations.[1] Whilst these canons of construction may appear on the face of things a fairly useful guide in assessing the rights of preference shareholders, three recent cases illustrate that these rights may adopt what Dean Elvin Latty described as 'mirage like qualities'.[2] The necessity to spell out in the articles of association or the letter of allotment every right which the preference shareholders may wish to enforce is clearly illustrated by these cases.

I shall not in this article attempt to discuss all the rules of construction that Professor Gower has enunciated. The three cases concerned, namely, *In the matter of Fowlers Vacola Manufacturing Co. Ltd.*,[3] *Re William Bedford Ltd.*,[4] and *In re Saltdean Estate Company Pty. Ltd.*,[5] deal specifically with certain canons or rules of construction enunciated by Professor Gower. The relevant rules are:[1]

> 3. If nothing is expressly said about the rights of one class in respect of either (a) dividends, (b) return of capital, or (c) attendance at meetings or voting, then, prima facie, that class has the same rights in that respect as the other shareholders . . .

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* Section 66 of the Uniform Companies Act provides that 'no company shall allot any preference shares . . . unless there is set out in its memorandum or articles the rights of the holders of those shares with respect to repayment of capital, participation in surplus assets and profits, cumulative or non-cumulative dividends, voting, and priority of payment of capital and dividend . . .' That requirement does not of course mean that there will not be difficulty and frequent questions of interpretation which the courts will be forced to resolve. In this article some of these questions are discussed.

1 GOWER, PRINCIPLES OF MODERN COMPANY LAW (2nd ed.), 341-343. (See also 3rd ed., 367-368.) The various cases cited by Gower in the footnotes to the various rules is an authoritative and full list of the leading cases in this particular area. Throughout this article I shall be referring to more recent cases (post 1957) which of course were not available to Professor Gower.

2 *Corporate Canzonet,* (1941) 10 DUKE BAR ASSN. J. 19 see below.

3 [1966] V.R. 97.

4 [1967] V.R. 490.

5 [1968] 1 W.L.R. 1844.

4. If, however, any rights in respect of any of these matters are expressly stated, that statement is presumed to be exhaustive so far as that matter is concerned. . . . The onus of rebutting this presumption is not lightly discharged and the fact that shares are expressly made participating as regards either dividends or capital is no indication that they are participating as regards the other—indeed it has been taken as evidence to the contrary.
7. Hence arrears even of cumulative dividend are prima facie not payable in a winding up unless previously declared. But this presumption may be rebutted by the slightest indication to the contrary. When the arrears are payable, the presumption is that they are to be paid provided there are surplus assets available.

The decision in the *Fowlers Vacola* case concerned the rights of preference shareholders to participate with the ordinary shareholders in a reduction of capital effected by the company when it found it had no need for certain excess capital due to the closing down of one of its lines of business. At the time the company was not in severe financial difficulty although it had sustained trading losses over a short period of time. In the *Saltdean Estate* case a preference shareholder objected to a reduction of capital whereby the whole of the preference share capital in the company was returned, together with a premium which, however, was a very small sum compared to the dividend the preference shareholders might have enjoyed had the directors of the company declared dividends representing the earned profits of the company. The *William Bedford* case deals with the rights of preference shareholders on liquidation of a company to recover arrears of dividends out of surplus assets. I shall deal with the *Fowlers Vacola* case and the *Saltdean Estate* case together because of their similarity in facts.

THE FACTUAL SITUATION IN FOWLERS VACOLA AND SALTDEAN ESTATE

Fowlers Vacola Manufacturing Co. Ltd. was a successful company incorporated and operating in Victoria. The issued capital consisted of 810,000 10s fully paid ordinary shares, and 45,393 £1 fully paid preference shares. The company's activities had included food canning, but, as a result of very intense competition in this particular line of manufacture, it had decided to abandon this activity. On doing this the directors found that the company's capital was in excess of its needs in the amount of £303,750. At a general meeting of the company a special resolution was passed to reduce the capital of the

company by this particular amount. This was to be effected by the return to the ordinary shareholders of 7.6d on every 10s share held by them and by reducing the nominal value of each of the ordinary shares to 2.6d. The company sought confirmation of this reduction pursuant to the Companies Act.[6]

The petitioning preference shareholders opposing the reduction[7] relied on a number of the clauses in the articles of association to support their contention that the reduction should not be approved by the Court. Article 2A provided inter alia that:

> the said preference shares conferred on the holders thereof the rights and privileges and are subject to the conditions following, namely . . . (ii) the right in the winding up to payment off of capital and all arrears of dividend whether earned or declared or not up to the commencement of the winding up in priority to the ordinary shares but without any further right to participate in profits or surplus assets.

The articles also contained the usual[8] modification of rights clause which provided:

> Whenever the capital by reason of the issue of preference shares or otherwise is divided into different classes of shares all or any of the rights and privileges attached to each class may be modified, commuted, affected, abrogated or dealt with, with the sanction of an extraordinary resolution passed by the holders of at least three-fourths in nominal value of the issued shares of the class at a separate general meeting of the holders of shares of that class.

No separate meeting of the preference shareholders had been called to consider the reduction, and indeed at the general meeting at which the special resolution was passed, the holders of a substantial number of preference shares voted against the particular motion. The persons petitioning held almost one half of the total preference shares issued by the company.

Little J. rejected the contention of the preference shareholders that the failure of the company to hold a separate meeting of preference

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6 s. 64 of the Victorian Companies Act 1961. This section is for the purposes of this discussion uniform throughout Australia.

7 The opposition was to the confirmation of the reduction of capital by the court. The holders of nearly one half of the issued preference shares joined in this objection.

8 See also art. 4 Table A 4th Schedule of the Companies Act. The limitations inherent in such an article are well illustrated by such cases as White v. Bristol Aeroplane Co. Ltd., [1953] Ch. 65; see GOWER, op. cit. n. 1 at 466-469. Cf. the clause in the articles of association in the Saltdean Estate Company which is in very similar terms.

shareholders was in breach of the modification of rights clause. The reduction did not involve a 'modification or affecting of the rights of preference shareholders' but rather the interference with 'the value of the rights', namely, the share itself. The preference shareholders were in effect losing some "security" with respect to their right to receive capital on a winding up. The company by distributing available funds to ordinary shareholders at this instance was reducing the common fund which might have been available to them at liquidation. The preference shareholders' main argument was centred around two propositions: (i) Where preference shares are, as in this case, given by the articles priority in the return of capital on a winding up, they have, 'on reduction of capital, a right to a similar priority in a repayment of capital in excess of the needs of the company'; and (ii) The reduction as effected did not comply with the "standards" of fairness and equity expected. The second argument was to succeed in this case but to fail in the *Saltdean Estate* case.

That company had capital consisting of 20,000 preferred shares of 2s each, and 50,000 ordinary shares of 1s each. The company had been very successful and dividends totalling 1,000% had been paid to the preferred shareholders during the seven years preceding September 1966. In March 1968 the company had standing to the credit of a revenue reserve the sum of £324,924. If dividends were to be distributed from this fund the preferred shareholders would receive payments equivalent to 1,625% of their shares. The company proposed a reduction of capital. A special resolution was passed in July 1968 to effect a reduction of capital by repaying the capital paid up on the preferred shares, together with a premium of 5s per share. No separate meeting was called of the preferred shareholders. The ordinary shareholders (dominated by one shareholder) approved the proposal and the preferred shareholders, apart from the petitioner who held 80 shares, also approved the proposal.

The articles of association contained a similar modification of rights clause to the one in the articles of association of Fowlers Vacola. Article 21 provided that:

> the nett profits of the company which the directors shall determine to distribute by way of dividends in any year shall be applied, first, in payment of a dividend at the rate of 10% per annum on the amounts paid up or credited as paid up on the preferred shares for the time being issued; secondly, in payment among the holders of the ordinary shares for the time being issued of a sum equivalent to the total sum paid by way of dividend to the holders of the preferred shares, and thirdly, the

> balance profits shall be divided as to 50% among the holders of the preferred shares and 50% among the holders of the ordinary shares for the time being issued.

The article dealing with return of capital on winding up (article 24) provided that:

> there shall first be paid to the holders of the preferred shares rateably the amounts paid up or credited as paid up thereon. The surplus assets (if any) shall be applied in re-payment of the capital paid up or credited as paid up, on the ordinary shares at the commencement of the winding up; and the excess (if any) shall be distributed among the members holding ordinary shares, in proportion to the number of ordinary shares held by them. . . .

The preferred shareholder argued (i) that the reduction of capital was a variation or modification of rights attaching to its shares, (ii) that the failure to obtain the approval of the preferred shareholders, as a class, would, if the reduction were approved, prevent a dissentient minority of preferred shareholders from availing themselves of the protection intended to be afforded to them by section 72 of the U.K. Companies Act of 1948[9] and (iii) that the proposed reduction was inequitable and unfair to the preferred shareholders, in that it was discriminatory against them.

THE VARIATION OF RIGHTS

A common argument in both the *Fowlers Vacola* and *Saltdean Estate* cases was that the reduction interfered with the rights of the preferred shareholders, and that in these circumstances the variation of rights clause requiring separate approval of the reduction was required to be followed.

In *Fowlers Vacola* as was noted above, the preference shareholders did not in any positive way have their rights interfered with or abrogated. Little J. referred to a long line of cases which clearly state that the use of words such as 'varied, abrogated, modified etc.' in no way prevent a resolution to 'impair' the 'enjoyment of rights'.[10] It is even doubtful whether Little J. was right in suggesting that the 'value' of the rights was affected by the reduction in a situation where the company's overall position was still a healthy one financially.

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9 Cf. s. 65 of the Victorian Companies Act 1961. The sections are very similar but in the Victorian (Australian) provision only 10% (15% in the U.K.) of the dissenters to a resolution "modifying etc." class rights are required to seek relief from the court.

10 [1966] V.R. 97, 103-104; see n. 8 above.

On the other hand in *Saltdean Estate* the cancellation of the shares meant that all the rights attaching to them were cancelled as well. It seems strange that a company can tell a specific class of shareholders—'we are eliminating you from participation in the company' —without giving them a right to vote separately on the proposition. Buckley J. referred to a statement by Lord Greene M.R. in *In re Chatterley Whitfield Collieries Ltd.*,[11] who said:

> It is a clearly recognised principle that the court, in confirming a reduction by the payment off of capital surplus to a company's needs, will allow, or rather require, that the reduction shall be effected in the first instance by payment off of capital which is entitled to priority in a winding-up. Apart from special cases where by agreement between classes the incidence of reduction is arranged in a different manner, this is and has for years been the normal and recognised practice of the courts, accepted by the courts and by business men as the fair and equitable method of carrying out a reduction by payment off of surplus capital. I know of no case where this method has, apart from agreement, been departed from. Every person who acquires shares in a company has only himself to blame if he does not know this, and I have no doubt that it is well recognised by business men.

This statement does not support the proposition that the failure of the company to obtain separate approval of the reduction was not a breach of the variation of rights clause. It is true that where a company provides by its articles for the possibility of reducing capital that shareholders should not be surprised if a proposal for reduction is considered and approved, but it is equally clear that shareholders would be very surprised that their opinion would not be sought in such a situation.

In any event the narrow language used in the variation of rights article permitted Buckley J. to conclude that this was a "cancellation of shares" and not a variation etc. of rights.[12] In these circumstances it was unnecessary for him, or for Little J., to consider the issue of whether section 65 of the Australian Uniform Companies Act (section 72 of the U.K. Act) had been circumvented. Jacobs J.[13] and Else-Mitchell J.[14] have disagreed on whether it is necessary to follow a variation of rights article contained in the articles and their views have been examined by the writer elsewhere.[15]

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11 [1948] 2 All E.R. 593, 596.
12 [1968] 1 W.L.R. 1844, 1848.
13 Crumpton v. Morrine Hall Pty. Ltd., (1965) 82 W.N. (Pt. 1) (N.S.W.) 456.
14 Fischer & Ors v. Easthaven Ltd., (1963) 80 W.N. (N.S.W.) 1155.
15 *The Variation of Class Rights,* 41 A.L.J. 490.

DOES PRIORITY ON WINDING UP GIVE PRIORITY ON REDUCTION OF CAPITAL?

Little J. was in some difficulty with this question in *Fowlers Vacola.* Buckley J., simply "interpreted" the articles of association of the Saltdean Estate Co., to find against the preferred shareholder. It is doubtful whether the preferred shareholder opposing the reduction argued this issue—the report of the case has but a passing mention of the problem[16] which was fully canvassed in *Fowlers Vacola.* In the case of *Re Isle of Thanet Electricity Supply Co. Ltd.,*[17] Wynn-Parry J., in the major judgment of the Court of Appeal, held that where articles of association set out the rights of preference shareholders in respect of dividends, return of capital etc., the contents of the articles of association were exhaustive. The silence of the articles or any other document which might be construed as a contract governing the rights of the preference shareholders meant that that shareholder had no further claim to profits or other advantages in respect of the particular company.[18] The Court of Appeal endorsed the dicta of Sargant J. in *Re National Telephone Co.,*[19] who stated that:

> the fact that an express right was given, in respect of dividend, to receive more than the amount of the preferred dividends in certain events strengthens the inference that the silence as regards the return of capital in a winding up indicates that there was to be no return of capital beyond the return of the nominal amount of the capital of the shares.

Little J. in *Fowlers Vacola* also endorsed the decision of the House of Lords in *Scottish Insurance Corporation Ltd. v. Wilsons & Clyde Coal Company Ltd.,*[20] which reached the same conclusion. His Honour however then went on to consider a number of statements which indicated that, whilst the rights of the preference shareholders to priority in winding up did not give them a right to a similar priority to have *excess capital* returned to them on a formal reduction of capital, priority was given to them as a matter of practice.[21] It should be noted that his Honour was limiting his comments to a position where there was *excess capital*; I shall return to this point shortly.

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16 [1968] 1 W.L.R. 1844, 1849.
17 [1949] 2 All E.R. 1060.
18 Id. at 1064-1065.
19 [1914] 1 Ch. 755, 769.
20 Referred to as the Scottish Corporation Case, [1949] A.C. 462.
21 [1966] V.R. 97, 102-103.

Little J. relied on the statement of Greene M.R. quoted previously.[22] This statement was approved by Lord Simonds in the House of Lords in that case[23] and was further endorsed in the *Scottish Insurance Corporation* case.[24] Buckley J. in the *Saltdean Estate* case specifically endorsed this statement but, as I have noted, extended it to apply to a situation it was not intended to cover.

Lord Evershed M.R. in the *Chatterley Whitfield* case was more realistic in assessing the rights of the preference shareholders. Referring to a passage in the 11th edition of Buckley on the Companies Acts[25] which stated that the silence of the articles on the rights of preference shareholders meant that they ranked pari passu with the ordinary shareholders, his Lordship continued:[26]

> Where, as in the present case, the contract between the preference shareholders and the company makes no express provision in regard to the rights and obligations on a return of surplus capital, it seems to me impossible on general principles to imply a contractual term that in the event of a surplus, preference capital shall be returned first.

Will the courts be as generous to preference shareholders where the company has suffered a loss and wishes to effect a reduction of capital? Lord Blanesburgh suggested in *Carruth v. I.C.I. Ltd.*,[27] that preference shareholders, if entitled to priority of return of capital on winding up, would be entitled to a similar priority where there was a reduction of capital to cover a loss of capital suffered by the company; but he limited his comments to 'a loss'. The preference shareholder accepts certain risks on becoming a shareholder in the company but it is normal for the company to offer certain advantages to offset the risks. These include the right to a preferred dividend and normally a priority to return of capital on the winding up of the company. Where a company has sustained losses and seeks a reduction of capital to offset these losses then even in the absence of a specific right entitling the preference shareholder to a return of his capital, the suggestion is that such a right will be granted if the shareholder is given such a priority on winding up.

But why should the shareholder be forced to accept a return of capital where the reduction is being sought in a situation where there

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22 See n. 11 above.
23 [1949] A.C. 512, 519.
24 See n. 20 above.
25 At p. 120 (12th ed. at p. 155; 13th ed. at p. 156).
26 [1948] 2 All E.R. 593, 606.
27 [1937] 2 All E.R. 422, 432-433.

are excess profits? Is it such a generally accepted business view that preference shareholders want to receive a return of capital in these circumstances? We would be surprised if preference shareholders receiving a handsome dividend of 10%, with the right to participate in any excess profits if declared, would welcome the opportunity to be relieved of their risk in having capital tied up in the company. It becomes quite apparent that the cost to the company of maintaining such a high dividend rate may well by the consideration that warrants a return of this class of capital, to be replaced, if capital is needed, by the issue of shares carrying a much less attractive dividend rate. The preference shareholders may however be unable to find such an attractive investment.

THE RIGHTS OF PREFERENCE SHAREHOLDERS TO SURPLUS "PROFITS"

The unusual provisions of article 21 of the Saltdean Estate Company raise a problem which has not been satisfactorily resolved. Do the surplus profits earned by a company such as the Saltdean Company become impressed with a label of 'these belong equally to all shareholders' which enables the preference shareholders to claim their share on a return of capital? This was an argument apparently relied on by the preferred shareholder in the *Saltdean Estate* case. It is based on a very liberal reading of the decision of the Court of Appeal in *In re Bridgewater Navigation Co.*[28]

The company was incorporated with ordinary shares but later preference shares were issued. The preference consisted of a preferential dividend of 5%.

The company was later voluntarily wound up and there remained, after all debts were paid out and capital returned, a surplus for division, and within the surplus certain reserve funds. The Court was asked to assess whether these represented undrawn profits which would then go exclusively to the ordinary shareholders or whether they were assets to be divided amongst all shareholders. If the "profits" had been capitalised they became assets of the company. Lindley L.J. denied the contention of the preference shareholder.[29]

> Carrying undrawn profits to a suspense account or to a reserve account does not necessarily change their character still less their ownership; they remain the undrawn profits of those persons to

[28] [1891] 2 Ch. 317.

[29] Id. at 327; see also Glenville Pastoral Co. Pty. Ltd. (in Liquidation) v. Comm. of Taxation, (1963) 109 C.L.R. 199, 207-208.

> whom they belonged, dedicated, no doubt, to certain purposes and applicable to those purposes, but not otherwise altered in their character or ownership. If the purposes for which such profits are set apart fail, or if the profits are not required for such purposes, they become divisible, not as capital, but as undrawn profits. When capital and profits belong to the same person and in the same proportions, it becomes unimportant to distinguish the one from the other, and capitalization for convenience may be inferred from slight evidence. But when capital and profits belong to different persons, or to the same persons in different proportions, the effect of capitalizing profits is to change their ownership, and an intention to do this must be shown before conversion of profits into capital can be properly inferred.

This analysis of the fate of the reserve funds was approved by the House of Lords in *The Scottish Insurance Corporation* case.[30] The decision is quite clearly a difficult one to uphold in the light of recent statements, particularly in tax cases, on the effect of an order that a company be wound up. Scrutton L.J. in *Inland Revenue Commissioners v. Blott*[31] stated that on winding up reserves become assets of the company returnable to shareholders in accordance with the priorities set out in the memorandum and articles of association. The House of Lords, when this decision went on appeal to it,[32] endorsed this view and it has since been accepted without apparent dissent.[33]

The issue of whether a similar transformation takes place on a reduction of capital has not been clearly adjudicated upon, although Viscount Haldane suggested that when a company decides to return profits to shareholders on a reduction of capital these profits become capital.[34] It is almost as though the reduction of capital is a miniature winding up or a partial winding up. The undistributed profits are of course completely at the control of the company acting in most cases through its board of directors. 'A shareholder is not entitled to claim that the company should apply its undivided profits in payments to him of dividend'.[35] Why should he then have the right to claim this, where no right is spelt out, on either a return of capital or a winding up?

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30 [1949] A.C. 462.

31 [1920] 2 K.B. 657, 675.

32 [1921] 2 A.C. 171; and see the later decision Inland Revenue Commissioners v. Burrell, [1923] 2 K.B. 478, 482 (per Rowlatt J.); affd. [1924] 2 K.B. 52.

33 See e.g. Federal Commissioner of Taxation v. Blakely, (1951) 82 C.L.R. 388, 402 (Fullagar J.).

34 Inland Revenue Commissioners v. Blott, [1921] 2 A.C. 171, 182-183.

35 Id. at 182, per Viscount Haldane.

In the case of *Re Isle of Thanet Electric Supply Co. Ltd.*[36] the preference shareholders sought a share in the surplus assets of the company. The articles of association of the company provided by article 3 the following:

> The issued preference shares shall confer on the holders the right to a fixed cumulative preferential dividend at the rate of £6 per cent. per annum . . . in priority to the ordinary shares, and the right to participate pari passu with the ordinary shares in the surplus profits which in respect of any year it shall be determined to distribute remaining after paying or providing for the said preferential dividend and a dividend for such year at the rate of six per cent. per annum on the amounts for the time being paid up or credited as paid up on the ordinary shares, and the preference shares shall confer the right in a winding-up of the company to repayment of capital, together with arrears (if any), and whether earned or not of the preferential dividend to the date of the commencement of the winding-up in priority to the ordinary shares.

The preference shareholder argued that the statement of principle by Lord Macnaghten in *Birch v. Cropper*,[37] that every person who became a member of a company limited by shares became entitled to a proportionate part of the capital of the company unless there were provisions to the contrary in the company's regulations, supported the claim to share in surplus profits. This statement however applies only in the absence of specific provisions. Where there were such specific provisions the equality is disturbed and indeed in so far as the preference shareholder is concerned where certain rights are set out these rights are exhaustive.[38]

Buckley J. in *Dimbula Valley (Ceylon) Tea Co. Ltd. v. Laurie*[39] applied the dicta of Lord Macnaghten as interpreted in later cases[40] to rule that preference shareholders were entitled to equal participation in surplus assets of the Tea Co. on its being wound up:[39]

> The share capital of the company incorporated in 1896 was divided into ordinary shares and preference shares. . . . Article 5 of the original articles of association provided: 'The ten thousand

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36 [1949] 2 All E.R. 1060.

37 (1889) 14 App. Cas. 525, 546.

38 [1949] 2 All E.R. 1060, 1064-1065.

39 [1961] 1 All E.R. 769 (These facts are taken from the headnote).

40 Such as In re Isle of Thanet Electric Supply Co. Ltd., The Scottish Insurance Corporation case and Prudential Assurance Co. Ltd. v. Chatterley Whitfield Collieries Ltd., [1949] 1 All E.R. 1094 (House of Lords approved the Court of Appeal in Re Chatterley Whitfield Collieries Ltd., [1948] 2 All E.R. 593).

preference shares in the original capital shall confer on the holders the following rights: . . . (b) The right in the event of the company being wound-up to be paid out of the surplus assets of the company, the amount paid up in respect of such preference shares and all arrears (if any) of dividend thereon up to the date of the commencement of the winding-up in priority to the other shareholders, and to participate in any further surplus assets of the company after payment of the amount paid up in respect of the other shares rateably with the other shareholders in proportion to the amount paid up on the said preference shares and the other shares respectively.' Article 85 of the original articles provided: 'Subject to the rights of members entitled to shares issued upon special conditions, the profits of the company, after setting aside such sum to a reserve as the directors may decide, shall be divisible among the members in proportion to the amount paid up on the shares held by them respectively . . .' Article 90 thereof empowered the directors to place profits to reserves. The original articles contained no capitalisation provision and no article in terms authorising the declaration of dividends, but the declaration of dividends was included among the business to be transacted at ordinary general meetings of the company. In 1946 the company adopted new articles, which included a capitalisation article.

In the *Dimbula Tea* case article 5(b) clearly provided that the preference shareholders were entitled to participate in surplus assets. Furthermore whilst article 85 stated the profits of the company were, after certain conditions were satisfied, to be divisible among the ordinary shareholders, it did not mean that these profits were impressed as it were with a stamp saying 'these belong to the ordinary shareholders'. Buckley J. distinguished *Re Bridgewater Navigation Company.*[41] There the equivalent of article 5(b) was interpreted in the way suggested by the ordinary shareholders. As has been noted, this decision may be regarded as of dubious authority (if not as bad law).[42] The *Scottish Insurance Corporation* case was distinguished on the terms of article 5(b)[43] of the Dimbula Company. Dr. Rice who

41 See n. 28 above. The article in the Bridgewater Navigation Company described the net profits of the company as 'belonging' to the ordinary shareholders. In the Dimbula Tea case the profits were to be 'divisible' among the ordinary shareholders—i.e. if they were declared: see Buckley J. [1961] 1 All E.R. 769, 777.

42 Or at the least limited to its facts: see Pickering, *The Problems of the Preference Share,* (1963) 26 MOD. L.R. 499: For a contrary view see Dr. D. G. Rice in a critical note on the Dimbula Ceylon Tea case: (1961) 24 MOD. L.R. 525.

43 The word 'divisible' was interpreted in the Scottish Insurance Corporation case as meaning 'That which is to be divided' rather than 'That which is capable of being divided'—see Buckley J. [1961] 1 All E.R. 769, 777.

criticised the decision of Buckley J. was, it is suggested, misinterpreting the importance of the *Bridgewater Navigation* case[44] (to put it at the highest). It is my view that Buckley J. was right on this question.

THE CONCEPT OF FAIRNESS AND EQUITY

To what extent should this govern the result of cases such as *Fowlers Vacola* and *Saltdean Estate*? The court has a wide discretion in confirmation of reduction of capital resolutions. Lord Cooper in the Court of Session in the *Scottish Insurance Corporation* case[45] dealt fully with this discretion noting that in early days the court viewed its task quite seriously. He went on:[46]

> It is significant that the authority selected by Parliament to confirm reductions of capital is not the Registrar . . . or any other administrative official but the court; it is abundantly plain . . . that the court's jurisdiction is a discretionary one, not confined to verifying the technical correctness of the formal procedure nor even to determine according to strict law the precise rights of the contending parties, but involving the application of broad standards of fairness, reasonableness and equity and the avoidance of what Lord Dunedin once described as 'a desolating logic' (*Balmenach-Glenlivet Distillery*).
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> Nothing could be clearer and more reassuring than those [early] formulations of the duties of the court. Nothing could be more disappointing than the reported instances of their subsequent exercise. Examples abound of the refusal of the courts to entertain the plea that a scheme was not fair or equitable, but it is very hard to find in recent times any clear and instructive instance of the acceptance of such an objection.

Buckley J. in the *Saltdean* case could find nothing to support the contention that the reduction was in any way unfair or inequitable. The relevant shares were redeemed with a premium of 5/- per share. In arms length dealings in the shares a short while previously they fetched about 11/- per share. He continued:[47]

> The fact is that every holder of preferred shares of the company has always been at risk that his hope of participating in undrawn or future profits of the company might be frustrated at any time by a liquidation of the company or a reduction of its capital properly resolved upon by a sufficient majority of his fellow members. This vulnerability is, and has always been, a

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44 24 MOD. L.R. 525, 527.
45 [1948] S.C. 360 (affd. [1949] A.C. 462).
46 Id. at 375 et seq.
47 [1968] 1 W.L.R. 1844, 1852.

> characteristic of the preferred shares. Now that the event has occurred, none of the preferred shareholders can, in my judgment, assert that the resulting state of affairs is unfair to him.

Did the majority in this case not act oppressively? There is no rule in English law that directors must declare dividends.[48] Indeed the dividends paid to the preferred shareholders were quite generous. Were the directors of the company acting bona fide in allowing the company to accumulate such vast reserves of undistributed profits[49] rather than distributing them to shareholders? Is it not feasible that the majority were clearly unhappy at the thought of sharing such wealth with the minority group of preferred shareholders (who were not holders of ordinary shares) and rather than continue to sacrifice their own interests in this continued policy decided to "buy out" the minority preference shareholders?

Courts do not generally intervene where directors (or shareholders) act in preserving control of the company. There have however been some mixed results. In *Harlowes Nominees Pty. Ltd. v. Woodside (Lakes Entrance) Oil Co.*[50] the High Court would not intervene where the directors issued new shares to a group, whom they knew would be in sympathy with their policy, rather than let the company be taken over, by means of share purchases, by a group which would be less sympathetic. Indeed the suggestion was made that the directors' financial policy was not a matter for the court.[51] On the other hand in *Hogg v. Cramphorn Ltd.*[52] the court prevented directors from interfering with a formal take-over bid for the shares of the company even though they honestly believed that the result would be harmful to the company.[53] A difficulty in arguing oppression in the U.K.[54] is the fact that the court, before it grants relief, must find

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48 See e.g. the statement of Viscount Haldane in Internal Revenue Commissioners v. Blott, [1921] 2 A.C. 171, 182.

49 The "limitations" that the courts are willing to place on the directors' financial decisions are of little substance: see generally Menzies, *Company Directors*, (1959) 33 A.L.J. 156; Parsons, *The Director's Duty of Good Faith*, (1967) 5 M.U.L.R. 395 and Dixon J. in Mills v. Mills, (1938) 60 C.L.R. 150, 183 et seq. Cf. Re Swan & Son Ltd., [1962] S.A.S.R. 310, which however turned on a number of instances of improper conduct, including the failure to pay dividends.

50 (1968) 42 A.L.J.R. 123.

51 Id. at 124.

52 [1966] 3 All E.R. 420.

53 Id. at 427. See also Piercy v. S. Mills & Co. Ltd., [1920] 1 Ch. 77 and Mills v. Mills, n. 49 above, and Re Swan & Son Ltd., n. 49 above.

54 Under s. 210 of the Companies Act 1948.

that the winding up of the company would be an acceptable alternative —there was no reason to suspect that such a course would in any way assist the shareholders of the Saltdean Estate Company. Such an alternative remedy is not necessary for an order to be made under the equivalent section 186 of the Australian uniform legislation.[55]

Little J. decided differently on the issue of fairness in the *Fowlers Vacola* case. He suggested that it was just and equitable on a return of capital where there were excess assets, to return preferred capital first.[56]

The opposition to reduction was large (holders of almost half the issued preference shares). In the light of this Little J. went on:[57]

> In the present case, the preference shareholders are not to participate even on an equal basis with the ordinary shareholders in the return of capital. They do not participate at all. They have not had the opportunity to express their views, let alone have they given their assent, at a separate meeting of the class. In making that observation, I have not overlooked that a separate meeting was not, as I have already stated, required by the articles. I merely record the fact as indicating that the case is not one in which the preference shareholders have at such a meeting given their approval. . . . The question is whether this scheme is fair and equitable. I can see nothing in the circumstances which in the interests of the company or in the interests of fairness as between classes requires or warrants the exclusion of the preference shareholders from participation in the contemplated return of capital. Bearing in mind the priority given in winding-up I should have thought that in the circumstances of this case fairness called for at least equality in treatment of the classes. It is sufficient to say that I am satisfied that the proposed return of capital to the ordinary shareholders and not to the preference shareholders is not fair and equitable and, that in my opinion, accordingly, confirmation of the reduction should be refused.

The reports in both cases do not reveal much in the way of details of other rights attaching to the preference shares. When did they have the right to vote? Did they have representation on the Board of Directors? These provisions may have been useful in assessing the justness and equity of the reduction—particularly in the *Saltdean Estate* case.

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55 For a discussion of this distinction see McPherson, *Oppression of Minority Shareholders,* (1963) 36 A.L.J. 427, especially at 434-435.

56 See n. 21 above.

57 [1966] V.R. 97, 106.

THE WILLIAM BEDFORD CASE[58] AND ARREARS OF DIVIDENDS

Canon of construction number 7 quite clearly throws the onus of rebuttal, in the case of silence on this issue in the articles or letter of allotment, on to the preference shareholder.

The facts of the above case were briefly as follows:[58]

> For several years prior to the winding up of a company, cumulative preference shareholders had not received any dividend. In realizing the assets of the company, the liquidator had a surplus of funds after paying out the preference and ordinary capital. The liquidator of the company applied to the Court for a determination as to the rights of cumulative preference shareholders to arrears of dividend out of a share of surplus assets on the winding up.

The memorandum and articles of association afforded no help in this case. The former contained no definition of the rights of the preference shares. By the latter the rights were left to be defined by the general meeting, or the directors, failing any action by the general meeting.

Adam J. turned to the prospectus inviting subscription, which contained the following statements on the rights of the preference shareholders:[59]

(1) The cumulative preference shares are preferential, both as to capital and dividend, taking priority to the ordinary shares, but after such preference is satisfied do not confer any rights to a further participation in profits or assets;
(2) The ordinary shares entitle the holders thereof (after prior payment of the cumulative preferential dividend of eight per cent per annum on the cumulative preference shares) to receive out of the divisible profits such a dividend on the capital for the time being paid up thereon as the directors may from time to time determine;
(3) The cumulative preference shares will confer on the holders thereof the right to receive dividends on the amounts from time to time paid thereon. Dividends on the cumulative preference shares will be payable half yearly.

Whether the preference shares carried with them a right to participate in surplus assets to the extent of arrears on dividends depended on the meaning of the expression 'preferential, both as to capital and dividend, taking priority to the ordinary shares'.[60]

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58 [1967] V.R. 490.
59 Id. at 492.
60 Ibid.

"Dividend" is a term which has a clear meaning. It refers to distribution(s) by a company to its shareholders when it is a going concern.[61] It is equally clear that as soon as a company is wound up no dividends are payable.[62] As has been noted earlier, the winding-up converts all profits into assets of the company and dividends are normally payable only out of profits.[63] Taxation legislation does of course at times give such words an extended meaning, but this is not relevant in this situation.[64] The preference shareholders in the instant case argued that "dividends" included arrears of dividend and this interpretation would allow the prospectus to be read, in the relevant part, 'as conferring on holders of cumulative preference shares preferential rights both as to capital and as to arrears of dividends'.[65] To reach such a conclusion counsel had to contend with a number of authorities where a similar issue had been the subject of interpretative analysis.

In *Re Walter Symons Ltd.*[66] the relevant clause relating to preferential dividend conferred the right to a fixed cumulative dividend which was to rank in priority to ordinary shares, and a similar priority was given to the paid up shares. But no further right to participation in profits or assets was given. Maugham J. in determining whether arrears of dividends were a valid claim on winding-up said:[67]

> . . . I think it is clear, that, but for the words 'and shall rank both as regards dividends and capital in priority to the ordinary shares,' the preference shareholders would not be entitled to claim in a winding-up payment of the arrears of fixed cumulative preferential dividend. . . . The question, therefore, is reduced to this: What is the true meaning of the words that I have last cited? . . . [T]he words 'but shall not confer the right to any further participation in profits or assets' seem to me to point very strongly in favour of the view that it is a clause which in this case is dealing with what is to happen in the winding-up . . .
>
> . . . I have come to the conclusion that the words 'dividends' should be construed as meaning 'arrears of fixed cumulative preferential dividend.' . . . That is derived from the use of the word 'cumulative' and I think the draftsman . . . was regarding a right to that dividend as existing notwithstanding the winding-up, and he is here stating that both as regards the arrears of fixed cumu-

61 Id. at 493.
62 Re Crichton's Oil Co., [1902] 2 Ch. 86.
63 See s. 376 of the Victorian Companies Act 1961.
64 See e.g. s. 47 of the Income Tax Assessment Act 1936-1968.
65 [1967] V.R. 490, 493.
66 [1934] Ch. 308.
67 Id. at 313-314.

> lative preferential dividend and as regards capital the preference shareholder is entitled to priority over the ordinary shares and I so decide.

Cohen J. distinguished that decision in *In re Wood Skinner & Co. Ltd.*[68] The relevant clause (clause 5) provided that the preference shares in that company[69]

> shall confer the right to a fixed cumulative dividend of 6 per cent. per annum on the capital paid up thereon and shall rank both as regards dividends and capital in priority to the ordinary shares with power to increase the capital.

He felt that Maugham J. had based his judgment in particular on the fact that the preference shareholders were given no right to participate further in profits or assets. He could find no reason for similar emphasis in the instant case.[70]

> . . . I think that it is reasonably clear on the authorities to which my attention was called, that the preference shareholders, had there been any surplus after repaying capital on both preference and ordinary shares, would have been entitled to participate pari passu with the ordinary shareholders in the distribution of the surplus assets. I do not think that the word 'rank', used in this connexion, is confined to winding-up. I think that it is intended to cover winding-up so far as capital is concerned, but that so far as dividends are concerned it refers to dividends in the strict sense of the word, i.e. while the company is a going concern. In my view, in the context of this case, the word 'dividends' is not exchangeable with arrears of dividend.

The English Court of Appeal in *In re F. de Jong and Company Ltd.* followed Maugham J.[71] The relevant article here provided:[72]

> the said preference shares shall carry the right to a fixed cumulative preferential dividend . . . on the capital . . . and shall have priority as to dividend and capital over the other shares in the capital for the time being, but shall not carry any further right to participate in the profits or assets . . .

On the liquidation of the company, the liquidator sought a ruling as to whether the preference shareholders were entitled to receive, out of the surplus assets of the company, the amount representing arrears on their dividends. Cohen J. held that the preference share-

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68 [1944] 1 Ch. 323.
69 Ibid.
70 Id. at 327.
71 [1946] 1 Ch. 211.
72 Ibid.

holders were entitled to receive arrears of dividends out of surplus. An ordinary shareholder appealed.

Morton L.J., in delivering the judgment of the Court of Appeal, held that the reference to priority attaching to the preference shares related to rights in a winding-up:[73]

> First, the provision giving priority as to dividend must, I think, refer to a winding-up because the word 'preferential' has already established the priority of the preference shareholders as to dividend, while the company is a going concern. Secondly, the words 'priority as to . . . capital' refer naturally to a distribution of the assets in the winding-up . . .
>
> The third reason is that one would expect to find somewhere in the articles provisions dealing . . . with the rights of the preference shareholders in a winding-up. Unless the passage which I have just read deals with those rights in a winding-up there is no provision at all informing the preference shareholders what their rights in a winding-up are to be.

He then interpreted the word 'dividend' to mean arrears of dividend. He held that the words 'but shall not carry any further right to participate in the profits or assets' stated clearly the full rights of the preference shareholders:[74]

> [These words provide] that the preference shareholders are to have no further right to share in the surplus profits while the company is a going concern, or in the surplus assets in a winding-up.

He distinguished *In re Wood Skinner & Co.* on the absence in the relevant clause of the words 'preferential' in describing the dividend and capital rights of the preference shareholders. He concluded that as priority had been provided for whilst the company was alive the relevant words had to relate to winding-up.[75]

In *Re E. W. Savory Ltd.*[76] the distinction drawn by Morton L.J. between the two cases was approved. Similarly Virtue J. in the *Collie Power Co. Pty. Ltd.* case[77] adopted this distinction and Adam J. in *Re William Bedford Ltd.* echoed the concluding remarks of Morton L.J.[78] in referring to the meaning of dividend:

> unless 'dividends' in that context is read as 'arrears of dividend', it is pure redundancy, because the clause has already provided

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73 Id. at 215.
74 Id. at 215-216.
75 Id. at 217.
76 [1951] 2 All E.R. 1036.
77 (1952) 54 W.A.L.R. 44.
78 In re de Jong & Co. Ltd., see n. 71 above.

> that the preference shares are to rank as regards dividends in priority to the ordinary shares.[79]

He could find no language in the prospectus which permitted him to extend the meaning of dividend in the instant case.[80] Referring to the specific clauses set out earlier his Honour stated:[80]

> . . . I may say in conclusion . . . that I am not persuaded that the [words]—'The cumulative preference shares will confer on the holders thereof the right to receive dividends on the amounts from time to time paid thereon'—throws any light at all on the present problem. It appears to me that that does no more than make it clear that the dividends payable in respect of cumulative preference shares are not to be paid on the face value of those shares but on the amounts paid up on those shares, and it was necessary—or at least desirable—to make some such provision in the prospectus where the moneys payable on these preference shares might be paid by instalments.

REFORM FOR PREFERENCE SHAREHOLDERS?

Pickering in 1963 summed up the unsatisfactory state of the law as revealed by earlier cases:[81]

> An undesirable proliferation of narrow verbal distinctions has emerged in the law relating to preferential share rights. These have been drawn in particular with regard to the entitlement of preference shareholders to arrears of dividends on a winding-up, to their entitlement in some circumstances to surplus capital, and to questions of the variation of the class rights. It has been well said in relation to the question of entitlement to arrears of preference dividend that 'The subtle distinction drawn in these cases should have no part in the construction of commercial contracts', and this is a criticism which generally ought not to be applicable to the definition of any of the rights of preference shareholders.

Some of the evidence heard by the Jenkins Committee[82] suggested that the law should be changed to prevent the arbitrary redemption of "irredeemable preference shares". The two House of Lords decisions in 1949[83] which decided that the consent of the preference shareholders to such a redemption was not necessary:[84]

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79 [1967] V.R. 490, 494.

80 Id. at 496-497. He however expressed regret at his decision: id. at 497.

81 See n. 42 above at 514.

82 REPORT OF THE COMPANY LAW COMMITTEE (referred to as The Jenkins Committee) Cmnd. 1949/1962.

83 Namely, the Scottish Insurance Corporation case [1949] A.C. 512 and Prudential Assurance Co. Ltd. v. Chatterley Whitfield Collieries Ltd., [1949] 1 All E.R. 1094.

84 Cmnd. 1749/1962 p. 72 para 195.

> roused strong feelings among preference shareholders generally and we sympathise with those investors who acquired preference shares on the assumption that they were irredeemable only to discover that they could be paid off at a time when it was impossible to re-invest their money except at substantially lower rates of interest than the preferential rate of dividend.

No change, however, was recommended. Current practice since 1949 showed that:[85]

> Preference shares which are quoted on the Stock Exchange have generally been issued on terms which adequately safeguard the interests of preference shareholders in the event of their moneys being returned either in a winding-up or on a reduction of capital, by linking the redemption price to the average market price during the previous six months. These terms are expressed in a formula known as the Spens formula. Cases where the holders of preference shares so quoted are liable to be prejudiced by the return of their money in unfavourable circumstances must by now be comparatively rare and will become rarer. This, it is true, does not apply to unquoted shares, in particular shares in private companies for which the Spens formula is inappropriate.

It is not known to what extent the Spens formula[86] is used in Australia. The position of the preference shareholders is still very uncertain. Apart from the question of the redemption of preference shares, the rights during the currency of their membership may also be less than real. Generally no very substantial voting rights are given to preference shareholders. In addition the ability of the directors to plough back excess profits in such a case as the *Saltdean Estate* case is not "fair and equitable". The Jenkins Committee was asked to recommend that:[87]

> a new Companies Act should provide that if a company creates preference shares carrying a specified rate of dividend, then, unless the articles or terms of issue specifically provide otherwise, those preference shares should carry certain defined rights.

It refused to make such a recommendation in view of the myriad varieties of preference shares. It did however recommend[88] that section 58 of the U.K. Act (section 61 of the Uniform Companies

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85 Ibid.

86 The Spens Formula is described in the extract from the Jenkins Committee report. See n. 85 above.

87 Cmnd. 1749/1962 p. 72 para 196. But see s. 66 (1) of the Uniform Companies Act.

88 Id. at 73 para 198 (g).

Act) should permit the conversion of preference shares into redeemable preference shares subject to the consent of the appropriate classes of shareholders.

Pickering suggests that the preference share is not in any "real" way a different "security" to debentures,[89] although legally a distinction exists. Certainly in Australia the very wide provisions of section 38 and the 5th schedule of the uniform companies legislation suggest that the interests of debenture (and note) stockholders receive very careful protection.

Unless all rights are clearly specified in the contract between the company and the preference shareholder, much confusion may still arise. Indeed Dean Elvin R. Latty in a verse entitled "Corporate Canzonet" emphasised the 'mirage like' qualities of the rights of preference shareholders in the U.S.A. and we find his ditty not inappropriate to explain the similar plight which may face the preference shareholder in the Australian 'desert'.[90]

> Are you ever tempted, ever stirred
> To become a holder of preferred?
> To own a share in a Delaware native
> By buying a stock that's cumulative,
> So income lost in leaner years
> Is saved by virtue of arrears?
> Friend, if you count on that arrearage
> You'll stay at home, or travel steerage!
> Arrears enjoy a legal place
> Quite like the 'heirs' in Shelley's Case.
>
> When times are lean, you're apt to smile
> Though dividends are passed a while,
> You spend no worried, restless nights,
> But comfort take in 'rearage rights,
> For soon the bad times will be over,
> Accruals put you back in clover.
> Then dividends will be resumed
> And all arrearages consumed.
> Until that time your own seniority
> Entitles you to full priority
> Over the lowly common shares.
> You'll get yours 'fore they get theirs.
>
> Friend, you'll be a wiser, chastened man
> On consummation of 'The Plan'.
> Corporations have the means

89 See n. 42 above at 514.

90 (1941) 10 DUKE BAR ASSOCIATION J. 19.

To cleanse the common's prior liens.
For one, they can amend the charter,
Or coerce you into dubious barter,
Creating a class of Prior Preferred
That leaves your own deep, deep interred.
These tactics failing your arrears to purge,
Behold! your corporation then will merge
Into its wholly owned subsidiary,
Or using novel means discretionary,
Incorporate in another state,
You are behind the ball marked '8'.

Perhaps the only way to resolve these difficulties is for the law to determine whether the preference share is to be a loan or a share interest. When this is done some progress may be possible in building a set of rules which will ensure that the "mirage like" rights will crystallise into a clearly defined "bill of rights" which will be a haven for the oft harassed "holders of preferred".

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