Thursday, October 26.

(Before Earl Loreburn, Viscount Haldane, Lord Kinnear, Lord Shaw, and Lord Parmoor.)

PATERSON *v.* R. PATERSON & SONS, LIMITED, AND OTHERS.

(In the Court of Session, February 17, 1916, 53 S.L.R. 404, and 1916 S.C. 452.)

Company—Articles of Association—Powers of Directors—Division of Profits—Creation of a Reserve Fund—Companies (Consolidation) Act 1908 (8 *Edw. VII, cap.* 69), *sec.* 11, *and Table A of First Schedule.*

The articles of association of a private company provided that table A of the first schedule of the Companies (Consolidation) Act 1908 should apply "only so far as they are not excluded, altered, or modified by the following provisions." Article 12 provided that "after allowing for all charges, including the payment of directors' salaries, the profits of the company shall be applied" in a particular way among the shareholders.

Held that article 12 was not consistent with clause 99 of table A, which provides for the directors setting aside out of profits sums to a reserve fund, and consequently that the directors had not power to do so.

This case is reported *ante ut supra.*

The defenders, R. Paterson & Sons, Limited, and the two directors thereof, appealed to the House of Lords.

At delivering judgment—

EARL LOREBURN—In this case I think the appeal ought to be dismissed. The question really lies in a nutshell. The company has placed to reserve the sum of £3000 out of the profits of the year. Can it do so lawfully? That will depend upon the articles of association. The 12th article provides that "After allowing for all charges, including the payment of directors' salaries, the profits of the company shall be applied as follows," and then comes the directions to which I will advert again. But then it is said that there is article 99 to be regarded, which appears in table A, the effect of which is that "The directors may before recommending any dividend set aside out of the profits of the company such sums as they think proper as a reserve or reserves." Are those two articles capable of standing together? Can they co-exist? Is the one of them excluded by necessary implication by the other according to the terms of the first article of association? There has been some discussion in regard to the meaning of those words, and I am extremely anxious to avoid undue subtlety. I will merely say that in my view in substance what you have to do is to lay them alongside one another without prejudice, and to see whether upon a fair construction they can be read together, or in other words can live together, to use the phrase used by learned counsel. I do not myself think that the one ought to be excluded if the two can be read together in such a way that the one is in some sense a qualification of the other. But we also have to look, and to my mind it is the most material thing certainly in this case, to the substance of the thing. When I examine the substance of the thing I find here that there is a direction in article 12 that the profits of the company shall be paid to particular participants and in particular proportions. When I look at article 99 I find that if they were to be applied only for a single twelvemonth in the creation of a reserve fund then the persons to whom the dividends would be payable might be different, and the proportions of dividends to be received might be different. When that is so I cannot think that article 99 can be admitted to be applicable in the face of article 12. Therefore I think that the appeal ought to be dismissed.

I hope your Lordships will not think it out of place for me to say that I think the House is very much indebted to the learned counsel on both sides for the assistance they have given us in this case.

VISCOUNT HALDANE—I agree. If this appeal had raised nothing more than a question of the internal administration of the affairs of the company, and the interpretation of a mere regulation governing the company's procedure, I should have thought that the objection *in limine* to the action was that the Court had no jurisdiction to entertain it. A reserve fund such as this is a thing which ordinarily the directors may set aside. It is not appropriated to or diverted from the proprietary rights of one person to the proprietary rights of another merely by being so set aside; it is something which even if what is done by the directors is done without sufficient authority, may be validated by a proper majority, and if necessary the articles may be altered. In such a case, and if that were all, I should have said that the matter was a domestic one with which no Court had jurisdiction to interfere. But it was agreed on all hands at the Bar, and I think rightly, that article 12 amounted to something more than a mere internal regulation of the company changeable at the will of a sufficient majority. It is apparent that this was a private company formed by three or four relatives for the purpose of managing a family business, and in article 12 they have embodied what is not merely a regulation, but, what could competently be made consistently with the statute, a contract *inter se* which must not be departed from, and which the Court is bound to enforce just as much as it is bound to enforce any other contract.

Now coming to the character of that contract, it is plain that the provisions of article 12 are to prevail over any provisions in table A which is incorporated. That is made quite clear by the first of the articles of association, which says "the regulations contained in table A . . . are to apply to this company only in so far as they are not excluded, altered, or modified by the follow-

ing provisions." Table A says, in article 99, that the directors may set up a reserve, and no doubt if they set up a reserve in the ordinary way they may take something out of profits. But is that consistent with article 12? I think not, for the reasons pointed out by my noble and learned friend on the Woolsack.

In the first place, article 12 says that "the profits of the company" without restriction or limitation are to be applied in the manner prescribed after allowing for all charges, including payments of directors' salaries, and I think "charges" must mean legal liabilities, and cannot include what the directors may in their discretion take out, or may name, as a reserve fund. Then it says the whole of the profits having been exhaustively dealt with in this fashion, they are to be applied in payment of certain dividends, which not only may in certain events go in one year to a different person from the one to whom they went in the preceding year, but may vary in the amounts to which different persons are entitled from year to year. That makes it a very material circumstance if the directors have the power to take out money and earmark it as carried to reserve, and for disposition even as profits on a future occasion, because the result of their so doing may by the terms of that article be to give the money to another person than the person who would have taken it had it not been so taken out and placed to reserve.

I am therefore of opinion that article 12 constitutes a family contract that the money which comes under the category of profits, after allowing simply for charges and a deduction for directors' salaries, which are carefully prescribed, is to be exhaustively disposed of. That is a contract which these people could make, and I think they have made it; and I think that disposes of the appeal and brings in the jurisdiction of the Court to enforce the contract like any other contract. I therefore agree that the appeal fails.

LORD KINNEAR—I agree with my noble and learned friends.

The question did not at first appear to me to be free from difficulty, but when one comes to understand it, it is, whether simple or not, at all events a very short question, and my opinion rests exactly on the grounds which my noble and learned friends have already explained. I think it is, as indeed was conceded by Mr Macmillan, a question of contract.

The parties, who are members of this trading company, have agreed by clause 12 of the articles of association, which has the effect of a contract *inter se*, that the profits of the company shall be applied in a certain specified way which is set forth in detail. So far as the directors are concerned, this is a peremptory mandate which they are bound to obey, and if they are so bound it follows that the profits must be distributed in the manner prescribed and in no other way. But then it is said that there is brought in a discretion by the 99th article in table A, which allows the directors to set aside a portion of the profits to reserve if they so think fit. Nobody disputes that that is a most reasonable discretion for directors to have, and that it may be an extremely useful one. But, then, is it consistent with an express direction in the form of a peremptory mandate that they shall distribute the profits in one particular way and no other? Table A is applicable to this company only in so far as its provisions are not altered, modified, or excluded by the company's own articles of association, and I am of opinion that article 99 is effectually excluded by clause 12. I come to this conclusion on two grounds—first, that the existence of any discretion in the directors is inconsistent with the absolute and peremptory character of the direction for distribution, and secondly, as my noble friend has pointed out, that in certain events the exercise of the supposed discretion under table A must necessarily defeat the rights created by clause 12. The question is one of construction of a contract, and I think the Court has answered it in the right way.

LORD SHAW—A substantial part of the argument before your Lordships has of course reference to the possibility of reconciling the provisions of article 99 of table A of the Companies Act with the provisions of section 12 of these articles of association. In my judgment they cannot be reconciled.

In the first place, the direction in article 12 is a mandatory direction, and is comprehensively mandatory in the sense of compelling the total distribution of the year's profits. I think that cannot be reconciled (a mandatory and comprehensive direction for total distribution of the profits) with an optional reserve out of the profits resulting in only a partial distribution.

In the second place, the word "profits" is in my opinion used in both article 12 and Schedule A in the same sense. It is notable that Schedule A deals with the creation of a reserve as the creation of a reserve made up out of "the profits of the company"—that is to say, not before but after profits have been struck. Accordingly when the 12th of these articles deals with "the profits of the company" and directs that they shall be totally distributed, it appears to me to be incompetent to allow alongside of that a process of arithmetic which should reduce the profits of the company by a sum ticketed to reserve and only allow the balance as ascertained to be distributed.

But in the last place I think these two articles cannot stand together, for this reason, that upon a sound construction of article 12 it appears to be clear, as already indicated from the Woolsack, that a certain set of people, namely, the shareholders for the year, not only will be entitled to receive the dividend, but to receive it in certain proportions set forth in the articles; whereas if there is not a distribution during that year, then in the course of a subsequent year there may be a distribution of profits to different persons and in different proportions to those which are provided in section 12.

Accordingly, it being clear that the two

articles cannot be reconciled, I ask myself what has section 12 of the articles provided in regard to the adoption or non-adoption of table A? It provides that in such a situation table A is no part of the constitution of this company. *Quoad* the items so altered, modified, or made irreconcilable with it, table A no longer need be invoked to disturb the mind.

I would further add, that that being my general view as to the correctness of the Court below, I attach little weight to the puzzle which was presented as to possible embarrassments in the conduct of this company by the non-creation of a reserve. I think it fair to say that, having looked to the accounts in this case, and having had indications from the argument, the suitability of creating a reserve in the case of many companies does not appear to me to be a strong argument in the present case. It is almost impossible to doubt that when the auditor of this company arranges or checks its balance-sheets there will be placed before him quite sufficient material within the accounts to enable the profits of the company in the sense of the article to be struck, after giving very large allowances in view of prudent administration—in the valuation, for example, of stock, goodwill, and the like.

Lord Parmoor—I agree in the opinions which have been expressed from the Woolsack and by the other noble Lords in this case. I think the method in which the case was approached in the argument of Mr Watson is the right way in coming to a determination. There can be no doubt that article 12 is one of the articles of the company in question, and constitutes a contract binding on the parties. Turning back to article 1 we find that "the regulations contained in table A in the first schedule of the Companies Consolidation Act 1908 shall apply to this company only in so far as they are not excluded, altered, or modified by the following provisions." And therefore in my opinion if on a true construction article 12 is inconsistent with article 99 in table A, the latter is excluded from these articles, and no question arises of one article being qualified by another.

I think that article 12 is quite clear. First of all as regards the term "profits" in article 12. The article directs that the profits of the company shall be ascertained after making allowance for all charges including the payment of the directors' salaries. Your Lordships have had the profit and loss account of the company placed before you, and I think no one can doubt that the figure of £20,143, 12s. 3d. has been properly ascertained as the profits of the company in accordance with the terms of article 12. Now when this amount has been ascertained there is a mandatory direction for its application. It is not the application of a part of this £20,143, or a disposal of profits after deducting an amount for a reserve fund. The method of application is clear. It is to be applied in certain definite payments under the heads (*a*), (*b*), (*c*). It is not necessary to go through each of those payments, but in (*c*) there is a provision that the balance which has not been distributed in accordance with (*a*) and (*b*) shall be distributed in accordance with (*c*), clearly showing in my opinion that the whole of the profits fall to be distributed, and not a proportion only.

Now not only is the direction mandatory, but also in my view it is clear that the result of the mandatory direction would be different in one year from what it might be in another if an amount in any year is placed to a reserve fund. I admit myself that I do not follow the argument that a reserve fund need necessarily at any time be distributed as profits. Other factors may supervene in the history of the company so that the fund may never be distributed as profits at all. It is not unusual in the case of companies of this kind, which have a large reserve fund, after a certain time to distribute it, not in the nature of profits but in the nature of additional capital. But beyond that, what I think is quite conclusive is, that if instead of the profits of the company being applied in immediate payment, they were applied partly in immediate payment and partly by application to a reserve fund, then even although in the future the reserve fund should be applied as profits, it does not follow that the same persons would have the benefit of those profits or that they would be distributed amongst them in the same proportions. It is not merely a question of words, but one of substance, and I admit that for my own part I can see no possibility of coming to any other conclusion than that the provisions of article 12 exclude, under the terms of article 1, the provisions contained in article 99 of table A.

In my opinion I think the judgments of the Court below are quite accurate.

Their Lordships dismissed the appeal, with expenses of the appeal against the two directors personally.

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