Privy Council Appeal No. 12 *of* 1963

Louis Steen and another - - - - - - - *Appellants*

v.

Charles Allen Law the Liquidator of International Vending Machines Pty. Limited - - - - - - - *Respondent*

FROM

THE SUPREME COURT OF NEW SOUTH WALES

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 2ND OCTOBER, 1963

Present at the Hearing:

VISCOUNT RADCLIFFE.
LORD JENKINS.
LORD MORRIS OF BORTH-Y-GEST.
LORD GUEST.
SIR KENNETH GRESSON.

[*Delivered by* VISCOUNT RADCLIFFE

This is an appeal from a judgment of Jacobs J. dated 20th December, 1961 and delivered by him while sitting in the Equity side of the Supreme Court of New South Wales. It relates to a claim made by the respondent as liquidator of a limited company, International Vending Machines Pty. Ltd. (hereinafter called " I.V.M.") against the appellants, requiring that they should repay to I.V.M. a sum of £200,000 which they as directors of I.V.M. had been responsible for advancing on loan to another company, A. M. Holdings Pty. Ltd. (hereinafter called " A.M.H."). The judgment appealed from held the appellants to be jointly and severally liable to repay £150,000 to I.V.M. with interest at the rate of 5 per cent. per annum from 25th June, 1959, the date when the loan was made, to the date of repayment.

The basis of the respondent's claim was that monies of I.V.M. had been advanced by way of a loan to give financial assistance for the purchase of its shares by A.M.H. contrary to the provisions of section 148 of the Companies Act, 1936, which contains a general prohibition of such transactions; and that the appellants, being at the time of this transaction the sole directors of I.V.M. and as such in control of its affairs, were guilty of misfeasance or breach of duty in causing this loan to be made. The appellants, although they raised many separate points of defence at the trial in the Supreme Court, confined their appeal to this Board to three issues only. The first, which concerns a general question of the interpretation of section 148 and, if answered in the appellants' favour, would mean that the statutory prohibition had not been infringed at all, depends upon the true construction of the words of sub-section (1) (a) of the section: the other two relate only to the particular facts of this case and affect the assessment of the quantum of loss inflicted upon I.V.M. by the actions of the appellants.

Section 148 is in the following terms:—

" 148. (1) Subject to the provisions of this section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase made or to be made by any person of any shares in the company:

Provided that nothing in this section shall be taken to prohibit—

(*a*) Where the lending of money is part of the ordinary business of a company, the lending by a company of money 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 by trustees of fully-paid shares in the company 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;

(*c*) the making by a company of loans to persons, other than directors, bona fide in the employment 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.

(2) The aggregate amount of any outstanding loans made under the authority of paragraphs (*b*) and (*c*) of the proviso to subsection one of this section shall be shown as a separate item in every balance-sheet of the company.

(3) If a company acts in contravention of this section the company and every officer of the company who is in default shall be guilty of an offence.

Penalty: " One hundred pounds." "

It is necessary now to set out briefly the relevant facts as proved at the hearing in the Supreme Court. In doing this their Lordships base their narrative as closely as possible upon the findings made by the trial Judge in his careful and considered judgment. It does not contain, since he did not think it necessary that it should contain, exhaustive findings upon all the facts which contribute to the whole story of the business venture of I.V.M., which began in June 1958 and was closed by a compulsory liquidation order in May 1961; but their Lordships agree with him in thinking that such findings as he did make are sufficient for the determination of all necessary issues in the case, and in their view his presentation of the facts certainly does not err on the side of showing any undue severity to the appellants.

I.V.M. then was incorporated in New South Wales as a proprietary company in June 1958. Its issued capital was £102, divided into 102 shares of £1 each, the appellants Louis and Joseph Steen holding 46 each and a relative, Sydney Steen, the remaining 10. At all relevant times the appellants were the only directors of the company.

The company's business was that of selling automatic vending machines to members of the public. At first, the machines were sold outright to purchasers who would operate them themselves, but in August or September 1958 a new business procedure was adopted. A number of merchandising companies, subsidiaries of I.V.M., was formed in different States of the Commonwealth, and, when a machine was sold, one of these companies was made to offer an undertaking to the purchaser that it would stock and operate the machine on his behalf. The merchandising company guaranteed to the purchaser a return at the rate of 20 per cent. per annum on what he had paid for his machine, receiving and retaining for itself any operating profits over and above this 20 per cent. I.V.M., on the other hand, though the recipient of the purchase price in full, allowed to its merchandising company no more than 10 per cent. of this sum as a contribution to the obligations undertaken by the latter.

The operating agreement between merchandising company and purchaser contained an undertaking that a guarantee fund, to secure the purchaser's 20 per cent. per annum return, should be set up in the names of independent trustees. It was the practice of I.V.M. to advance to the fund the whole or part of the monies required to make good this guarantee and thus, to the extent that the advances exceeded the 10 per cent. of the gross purchase price which I.V.M. owed to the merchandising company on a sale, the former could be regarded as lending money from time to time to the latter in the furtherance of its business.

It was not determined during the course of the case whether the method of dealing adopted by I.V.M. had involved it in liability to all or some purchasers in respect of their guaranteed return. It was a question which, at any rate by March 1959, had engaged the attention of the company's professional advisers; but an answer to it would not have any significant bearing on the issue as to the appellants' liability in these proceedings, since it is clear from the evidence of Mr. Louis Steen, the father of the other appellant, that the two directors had always realised that, whatever the strict legal position, I.V.M. would have to " support " the guarantees given to purchasers, since " these companies were a group of companies, each and everyone dependent on the other . . . I regarded the entire group as virtually one company."

I.V.M.'s accounting year ended on the 30th June. Its accounts for the first year, that ending 30th June, 1959, showed a net profit of something over £263,000. For the second year, ending 30th June, 1960, no precise figure seems to have been put in evidence, but, as its income tax for that year amounted to £139,726, it must have been a substantial sum. These returns of profit were treated as representing true profits for the purposes of the case and they have been made the basis of tax assessments. Their Lordships therefore accept them in the same way, but without assuming that on a closer analysis of I.V.M.'s course of trading they would necessarily emerge as true distributable profits. In fact the evidence shows that out of the £263,280 16s. 11d. shown as the profit as at 30th June, 1959, £150,000 was transferred by the directors to " General Reserve for Contingency on Guarantee " and only £13,780 16s. 11d. was shown in the Profit and Loss Appropriation Account as attributable to Shareholders' Funds.

The circumstances in which the impugned loan of £200,000 came to be made can now be related. They arose from the desire of the appellants that their company should escape the liability to tax on its undistributed profits that would accrue if by the end of the financial year 1958/59 it remained a private company within the definition provided by Division 7 of Part III of the Commonwealth Income Tax and Social Service Contribution Act, 1936–1959 and within the succeeding ten months no satisfactory distribution of its profits had taken place. The company's accounts for the six months ending 31st December, 1958, had already shown a net profit of over £53,000, and it was apparent that, unless the existing basis was changed or substantial dividends were declared, there would be a very heavy tax liability for the whole financial year. This matter was engaging the attention of I.V.M.'s accountants and auditors by the month of March, 1959. A profit of something of the order of £200,000 was by then anticipated for the completed year, and the situation placed before the appellants was that, if they declared dividends out of the profits, they would bear personal tax on those dividends, whereas, if they did not declare dividends, the company would be liable for undistributed profits tax as well as primary tax.

The appellants instructed two representatives of their accountants, Mr. Mann and Mr. Purcell, to have a consultation with a Mr. Challoner, a taxation expert, to see what course of action he could recommend. The result of two meetings with Mr. Challoner was that early in June 1959 Mr. Purcell returned to the appellants with the assurance that he had " solved the taxation problems that the company had " and the outline of the arrangement that was to achieve this desirable result.

The arrangement was to be as follows. I.V.M. was to be turned into the wholly-owned subsidiary of a public company and as such would be liable only to primary tax. The public company that would hold the I.V.M. shares was to be formed in Canberra with the required number of separate shareholders, and the appellants and Sydney Steen would sell to it all their shares in I.V.M. for the sum of £200,000. The basis of this figure of £200,000 was never satisfactorily explained: the learned Judge formed the opinion that it had been fixed upon at an early stage in the discussions, before the conferences with Mr. Challoner, and that it remained throughout the figure which it had been determined would be received by the three Steens. The money itself which the new company, A.M.H., was to pay the Steens would be found by I.V.M. advancing it on loan to A.M.H. A.M.H. would transfer

it to the Steens against transfer of their shares; and the Steens in turn would deposit the money back into I.V.M.'s account, each obtaining a credit for his share of the money thus returned.

This arrangement was accordingly put into effect between the beginning and the end of June 1959. The companies concerned were put through the required legal exercises, but, as the appellants were the sole directors both of I.V.M. and A.M.H., everything that was done was in fact the product of their joint decision. I.V.M. was made to provide A.M.H. with a cheque for £205,000. A.M.H. paid £90,000 to Louis Steen for his 46 ordinary shares in I.V.M., a similar sum to Joseph Steen for his shares and £20,000 to Sydney Steen for his holding of 10. Thus A.M.H. became the sole beneficial holder of I.V.M. shares, each of the appellants retaining one share as nominee of A.M.H. It had no other assets of any substance.

The three Steens each took up a small holding of £1 convertible preference shares and ordinary shares in A.M.H. Its status as a public company was secured by the issue of 25 separate blocks of 50 redeemable preference shares to certain companies and persons. Moreover on the 25th June, a further inter-company transaction was put through. Louis Steen and Joseph Steen each subscribed for an additional 22,500 of the convertible preference shares and 5,000 more went to Sydney Steen. The monies for these were provided out of their respective loan accounts with I.V.M. On the same day A.M.H. subscribed for 50,000 ordinary shares of £1 each in I.V.M., the monies provided by the Steens for their additional shares being thus returned immediately to I.V.M.'s resources.

The position therefore by the end of June 1959 was as follows. I.V.M. had made a loan of £200,000 (the total in fact, was £205,000) to A.M.H., without security and apparently without interest. A.M.H. had no substantial asset except I.V.M. shares. The Steens had received £90,000, £90,000 and £20,000 respectively for the sale of their shares in I.V.M., and they had, as arranged, deposited the sums received to their credit with I.V.M. Since between them they owed a total of £77,972 7s. 2d. to the company on drawing accounts, Louis £38,568 11s. 3d., Joseph £38,283 15s. 11d., and Sydney £1,120, the effect of the deposits of their respective proportions of the £200,000 purchase money was to convert their debits into credits and, after allowing for their drawings on 25th June in respect of A.M.H. shares, Louis was left with £28,931 8s. 9d. in credit, Joseph with £29,126 and Sydney with £13,880. No reluctance was shown in drawing the balance of these credits out of the company. By the end of the year 1959 they had exhausted them: in other words, as the learned Judge said, they had each received from the company the balance of the moneys which had been paid to them by A.M.H. and which had in turn been paid by them to the company.

These facts, as established, present a clear case of a limited company giving financial assistance for the purpose of facilitating a purchase of its shares. Such assistance is forbidden by section 148 of the Companies Act, 1936, subject to the saving effect of the three provisoes to subsection (1). The trial Judge made no positive finding as to the extent to which the appellants, who put the whole operation through, knew that they were acting in breach of section 148. There was no evidence, he said, that they did know: on the other hand, despite their own testimony and that of Mr. Purcell, he was not prepared to accept positively that they did not. There the matter can be left, for their Lordships are at one with the learned Judge in thinking that, where directors have used their directorial powers to part with monies of their company in a manner or for a purpose which the law forbids, it is not a defence to proceedings to make them liable for their action to plead merely that they acted in ignorance of the law.

Nor was this proposition advanced before the Board on behalf of the appellants. The main submission relied upon in their defence was that they were protected by proviso (*a*) of subsection (1), in that the lending of money had been part of the ordinary business of I.V.M. and that the provision of £200,000 to finance the purchase of the shares of the Steen family was a lending in the ordinary course of its business. It might not be difficult to

reject this argument merely by denying the basis of fact on which it proceeds and by insisting instead that the lending of money had no more formed part of I.V.M.'s ordinary business than the £200,000 had been provided, in any intelligible sense of the words, in the ordinary course of its business. But there seems to have been very little judicial exposition of the meaning of proviso (*a*) since it was first introduced into company legislation, and in deference to the cogent arguments that were advanced to their Lordships on this issue they will deal with the interpretation of the proviso in more general terms.

The section in question first appeared in the law of New South Wales in the year 1936. As it had been introduced into the United Kingdom a few years earlier as section 45 of the Companies Act of 1929, it is safe to assume that the later piece of legislation took its inspiration from the earlier. There is no difficulty in describing the notorious objections to a company's money being used to assist the purchase of its own shares (see, for instance, the practice described by Greene M. R. in *In re V.G.M. Holdings* [1942] Ch. 235), but the question that now calls for consideration is what is the scope and nature of the various exemptions allowed by the section from its general prohibition of money being provided for such purposes.

When provisoes (*b*) and (*c*) are contrasted with proviso (*a*), it seems clear that the second and third are intended to take care of situations different in kind from that envisaged by the first. What they exempt are loans or other transactions which are explicitly designed by the lender to make possible what would otherwise be directly prohibited by the general words of the section—the purchase of employees' shares by trustees under an established company scheme or the purchase by employees, not being directors, of shareholdings in the company for their own beneficial purposes. Purchases of these two kinds fall within limited and defined categories: the section envisages (see subsection (2)) that each loan made for either of these reasons will admit of identification as such and that the aggregate amount of such loans outstanding at the date of any balance sheet will be capable of precise computation and statement.

Proviso (*a*) on the other hand is expressed in different terms. Whatever exemption it confers is not described in relation to the purposes for or in connection with which the money is made available, nor, it seems, are monies loaned in reliance on this proviso envisaged as admitting of identification according to the purpose of the loan. If it were otherwise, what could be the reason of requiring the aggregate of outstanding loans made under (*b*) and (*c*) to be shown in the balance sheet, but not of making any similar requirement with regard to loans protected under proviso (*a*)?

This proviso then must be read not as exempting particular loan transactions made for identifiable purposes but as protecting a company engaged in money-lending as part of its ordinary business from an infraction of the law, even though monies borrowed from it are used and, perhaps, used to its knowledge, in the purchase of its own shares. Even so, the qualification is imposed that, to escape liability, the loan transaction must be made in the ordinary course of its business. Nothing therefore is protected except what is consistent with the normal course of its business and is lending of a kind which the company ordinarily practises.

In their Lordships' opinion such an approach to the interpretation of proviso (*a*) necessarily requires that " the lending of money ", to be part of the ordinary business of a company, must be what may be called a lending of money in general, in the sense, for example, that money lending is part of the ordinary business of a registered money lender or a bank. Such lenders are not obliged to accept their borrowers; but it is characteristic of their business that, if they do lend, the money made available is at the borrower's free disposition and is not, except in special circumstances, confined to special uses or restricted to particular and defined purposes. Unless the lending of money as part of the ordinary business of a company is understood in this sense, the absurd result would be reached that any lending operations of which it made a practice, however restricted their purpose or remote from

general money-lending, would qualify the company to ignore the prohibition of the section and finance purchases of its shares, provided that it could describe such advances as made in the ordinary course of its business. Thus a company which, for instance, lent money from time to time to trade suppliers or purchasers could claim that the lending of money was part of its ordinary business and that it was accordingly one of the companies intended to be protected by proviso (*a*), if it chose to make loans in connection with the purchase of its shares. Yet it is not possible to suppose that the section could have been intended to provide any exemption or relief for such cases, for there could be no good reason for allowing a company to use previous lendings for quite different purposes as the justification for share purchase loans, which the legislation is in general intended to forbid.

This intepretation is supported by the fact that in the proviso the " ordinary business of the company " is associated with " lending . . . of money in the ordinary course of its business ". The latter words are not intended, their Lordships think, to be synonymous with the " ordinary course of business " itself and seem to refer more particularly to advances of a scale and for a purpose similar to those regularly made by the company in carrying out its business. Such a construction accords naturally with the idea of general money lending, provided that the advances do not amount to a departure from the usual order of business: but it is, on the other hand, virtually impossible to see how loans, big or small, deliberately made by a company for the direct purpose of financing a purchase of its shares could ever be described as made in the ordinary course of its business.

Now the only lending of money in which I.V.M. can be said to have taken a part since it set up its business was the inter-company transfers of funds which were made to enable the merchandising companies to fulfil their obligations and support the guarantee fund and the drawings of company monies on loan account by the three members of the Steen family. Neither type of operation was effected on commercial terms or at interest. In their Lordships' opinion such operations did not render the lending of money part of the ordinary business of I.V.M. within the meaning of proviso (*a*) to section 148 (1), and it follows that the advance of the £200,000 was not a loan that was protected from the ban imposed by the section.

In the argument before the trial Judge reliance was placed upon the decision of Cozens-Hardy J. in *In re H. H. Vivian & Co. Ltd.* [1900] 2 Ch. 654 to support the view that the £200,000 was loaned in the ordinary course of I.V.M.'s business, and the same argument was pressed before this Board. In the opinion of the Board it would be a misuse of authority to suppose that the *Vivian* decision has any bearing at all upon the meaning or application of the proviso now under consideration. The case arose out of a motion in a debenture-holders' action, in which it was sought to restrain the company from selling one of three businesses which it had been conducting, without first making provision for the security of its debenture holders, who held a floating charge upon its assets. What was at issue therefore was the question whether the intended sale had caused the charge to crystallise into a fixed charge, and this question depended upon the further question as to the understandings, express or implied, upon which a company that has created a floating charge is at liberty to deal with its assets without provoking the intervention of the holders of the charge.

The company had annexed to its charge an express covenant to carry on its business in " a proper and efficient manner ". Apart from this there may have lain behind the covenant a general understanding of the parties that anything that amounted to a cessation of business or to a major departure from its normal course would cause the floating charge to attach specifically to the assets of the business as they then stood. All that was decided by Cozens-Hardy J. however was that, as the charge had been imposed upon the business as one entity, comprising the three separate branches, and the express undertaking was to carry on that business in a proper and efficient manner, a disposal of one of the three, the others continuing, did not constitute any breach of that covenant. He did not say, but he may have implied, that the sale did not in his opinion amount to such a change of the company's undertaking as to terminate its liberty to deal with its assets in the ordinary and

proper course of its business. It is however one thing to say that a company which is continuing its business has by disposing of a branch of it dealt with that part without interrupting the ordinary course of its business: it would be a very different thing to say that it would be in the ordinary course of its business to enter upon some venture or transaction that was quite alien to any activity that it had previously been concerned with. In truth, there is no useful analogy to be found between such an operation as a disposal of one branch of a continuing business for the purpose of more efficient trading and the parting with a considerable portion of its available resources for the purpose of facilitating a purchase of its own shares. The case of *In re H. H. Vivian & Co. Ltd.* supra throws no light upon the construction of proviso (*a*) of section 148 (1), and their Lordships are satisfied that the monies advanced cannot be spoken of as lent by the company in the ordinary course of its business.

The second point taken on behalf of the appellants was that the learned Judge, in holding them liable for repayment of £150,000, had in any event over-estimated the amount of the company's loss. In fixing the figure at £150,000 he had given them credit for the £50,000 which they had returned to I.V.M. through the instrumentality of A.M.H., when they took up A.M.H.'s new shares in order to enable it in its turn to subscribe for 50,000 new ordinary shares in I.V.M. The respondent in fact was prepared to dispute the propriety of even this allowance to the appellants, not by way of cross-appeal to increase the figure of liability beyond £150,000 but as a set-off against any further reduction of that sum that they might obtain by making good the point which has now to be considered. As their Lordships are against the appellants on this point, the respondent's argument on the allowance of the £50,000 does not require further notice.

What the appellants say is that they ought to get credit in any repayment that they are ordered to make for the tax saved to I.V.M. in respect of its 1958/59 profits by the fact that before the close of the year it had become the wholly owned subsidiary of a public company and as such exempt from liability to undistributed profits tax.

There are no materials available which make it possible to say what the figure of tax saving should be taken to be. The sum of £101,073 was agreed at the trial to represent the amount of undistributed profits tax which the company escaped in respect of the two years 1958/59 and 1959/60. But then the appellants' counsel conceded that no credit could be asked for in respect of the tax saved in the second year, 1959/60, and the sum of £101,073 would in any event therefore have to be reduced by deducting the portion of it attributable to that year. Secondly, as the respondent's counsel pointed out, the tax saving obtained by I.V.M. ceasing to be taxable as a private company was not all net gain, since by becoming taxable as a public company it incurred a higher rate of ordinary or primary tax than would otherwise have been payable. This too was conceded, though the required adjustment was not known. In the result the credit at stake in respect of tax saving can be referred to as £X.

Why then should the appellants get credit for these £X against the sum of money which they improperly compelled I.V.M. to pay away? Because, they say, the tax saving came about through the scheme which they initiated of forming A.M.H. as a public company and enabling it to become the owner of all their I.V.M. shares, and I.V.M.'s £200,000 were required to pass from it to A.M.H. and from A.M.H. to themselves in order that this scheme could be carried out. And so they were, given the assumption that the three Steens had to be recipients of £200,000 in order that I.V.M. should be able to save undistributed profits tax in respect of 1958/59. But this is where there lies a fallacy in their claim. There were several possible alternative methods which could have been adopted if the only object was to achieve this tax saving, and the loan of £200,000 by I.V.M. to enable them to be paid cash for their shares was not essential for that single result. To take an obvious example, they could have sold their shares to A.M.H., not for immediate payment, but against payment in instalments at such time as A.M.H. came to be legitimately in funds through receipt of dividends on

its I.V.M. shares. The fact was that they adopted the method which both suited them and at the same time involved the making of an illegal loan by I.V.M., and, although the trial Judge's findings are not explicit on the point, he clearly regarded it as having been a settled part of the scheme from its first inception that the Steen shareholders should be placed in possession of this sum of £200,000.

It was that consideration that led him to say, in rejecting the appellants' claim for a credit on account of the tax-saving, that there was " no such relationship between the illegal loan and a possible saving of tax thereby that it can be said that the result of the illegal loan was a saving of tax ". In their Lordships' opinion that is a correct formulation of principle. Once it is apparent that a saving of tax could have come about independently of the forcing of the company into the prohibited loan, the essential link between the loan and the saving is broken, and the appellants cannot be allowed to reduce the amount for which they are initially liable by calling in aid the tax saving which accompanied their own illegitimate benefit at the expense of the company's resources.

Lastly, some complaint was made of the order in the Supreme Court in that it required the appellants to pay interest at the rate of 5 per cent. per annum on the £150,000 loss as from the 25th June, 1959 to date of payment. The only point on that is that the Steens did in fact immediately return to the company the £200,000 they received, subject to extracting £50,000 of it for the purpose of taking up the 50,000 new A.M.H. shares. As their individual drawing accounts, apparently, neither credited nor debited interest, it is correct to say that the company had enjoyed the use of the monies to their credit on those respective accounts for some period which overlapped that for which the order charges them with interest. But the learned Judge had already pointed out in the narrative part of his judgment that after the 30th June the appellants and Sydney Steen continued to operate on their loan accounts and that by the end of the year 1959 they had withdrawn from the company the whole of the credit balances which appeared in their loan accounts at the 20th June of that year. In other words the company had received the benefit of the returned monies (of which £77,000 was a mere replacement of drawings) for a few months only and in diminishing amounts. Considering that the Steens had been enjoying the use of its monies, without interest, on their loan accounts up to the 30th June, the small amount of overcharge on the one hand can be set against the undercharge on the other, and their Lordships see no good reason for disturbing the order appealed against on the matter of the interest charge.

Their Lordships will humbly advise Her Majesty that the appeal should be dismissed. The appellants must pay the respondent's costs.

(88319) Wt. 8052/97 70 10/63 Hw.

In the Privy Council

LOUIS STEEN AND ANOTHER

v.

CHARLES ALLEN LAW THE LIQUIDATOR OF INTERNATIONAL VENDING MACHINES PTY. LIMITED

DELIVERED BY

VISCOUNT RADCLIFFE

Printed by HER MAJESTY'S STATIONERY OFFICE PRESS,
HARROW

1963