

# **CORPORATIONS LAW**

## **CASE NOTES**



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SAMPLE

## ***Trevor v Whitworth* [1887] 12 App Cas 409**

**Source:** Hard copy via your law library or electronically via a subscription service.

**Court details:** House of Lords.

**Procedural history:** The case was heard on appeal from the Court of Appeal.

**Facts:**

- The appellants were Trevor and another.
- The respondents were Whitworth and another.
- The company, James Schofield & Sons Limited was incorporated in 1865 under the *Companies Act 1862* (UK). The objects outlined in the memorandum of association were:
  - to acquire and carry on the business of certain flannel manufacturers, and
  - any other businesses and transactions which the company might consider to be in any way conducive or auxiliary thereto, or proper to be carried on in connection therewith.
- The memorandum did not authorise the company to purchase its own shares.
- Several of the company's articles of association detailed share purchases by the company. Here, the Court considered only the following two:
  - Article 179: 'Any share may be purchased by the company from any person willing to sell it, and at such price, not exceeding the then marketable value thereof, as the board think reasonable' (409-410).
  - Article 181: 'Shares so purchased may at the discretion of the board be sold or disposed of by them or be absolutely extinguished, as they deem most advantageous for the company' (410).
- Whitworth sold his shares in the company to the company in 1880 under an agreement to be paid in two instalments.
- He received the first instalment but before receiving the second, he died.
- The company went into liquidation in 1884.
- Trevor was appointed as the liquidator.
- The executors of Whitworth's estate applied to Trevor for the outstanding balance of funds owed through the share sale.
- At first instance, the Vice-Chancellor of the County Palatine of Lancaster declared, 'the claim against the company ought not be allowed' (410).

- On appeal, the Court of Appeal reversed the decision and allowed the claim.
- The liquidator, Trevor, appealed the decision of the Court of Appeal.
- Counsel for the appellants argued:
  - ‘The purchase of its own shares by a limited company incorporated under the *Companies Act* is *ultra vires* and invalid, and this whether there is or is not power given in the memorandum of association. It is not indeed necessary to go that length in the present case, for the memorandum gave no power to the company to purchase its own shares, and the memorandum cannot be extended to objects foreign to its scope by the articles of association. That portion of the articles therefore which authorises such a purchase is invalid and the contract of purchase was *ultra vires*, and no subsequent ratification could avail anything’ (410-411).
- Counsel for the respondents argued:
  - ‘the articles of association must be construed so as to authorise only such purchases as would be consistent with the memorandum: that here the purchases was or might be incidental to the carrying on of the business of the company, and was therefore authorised, by the memorandum. That it might well be necessary to buy out hostile shareholders or to prevent nominees of a rival company from becoming shareholders’ (411).

**Issue:** Here, the issue was whether the company could purchase its own shares.

**Reasoning / Decision (Commentary):** The House of Lords determined the company acted outside its power. The purchase of its own shares (even if permitted in its articles) was deemed void and Whitworth’s claim for the balance failed. The fundamental principle underlying the decision was that the capital of limited liability companies should be maintained to satisfy creditor claims. This is because creditors assume risk in their outlay associated with business transactions and as such, the law ranks them ahead of shareholders when capital is returned.

The case has become authority and known as ‘the rule in *Trevor v Whitworth*’ whereby a company is generally permitted from reducing its share capital because it will prejudice the interests and rights of creditors. This has been incorporated in s 259A of the *Corporations Act 2001* (Cth) however, there are exceptions to the rule.

**Ratio:**

- Lord Herschell (Lord FitzGerald concurring): His Honour quoted and affirmed Cotton LJ in the case of *Guinness v Land Corporation of Ireland* (1883) L.R. 22 Ch. D. 349: ‘From that it follows that whatever has been paid by a member cannot be returned to

him. In my opinion, it also follows that what is described in the memorandum as the capital cannot be diverted from the objects of the society. It is, of course, liable to be spend or lost in carrying on the business of the company, but no part of it can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid' (419-420).

- Lord Watson (Lord FitzGerald concurring): His Honour considered, 'It was not an isolated transaction with a single troublesome shareholder' who was obstructing the business of the company, but was part and parcel of a scheme carried out by the directors under the articles of association, by which they acquired for the company more than one-fourth of the whole shares of its undertaking, and returned to the shareholders from whom they purchased more than one-fourth of its paid-up capital. It does not appear to have formed any part of the scheme to re-sell or re-issue the shares ; and matters stood in the position I have described at the date of the liquidation. I do not doubt that, as suggested by the learned judges of the Court of Appeal, the object of the directors was to keep "James Schofield & Sons Limited" as a sort of family concern, which was a perfectly lawful object if pursued by legitimate means. But the directors and shareholders of a company limited by shares who desire to have the concern in the hands of themselves and their friends, and to keep its shares out of the market, ought to use their own money for that purpose and not the trading capital of the company. In my opinion the application of the company's funds in furtherance of any such object is altogether illegitimate, because it is foreign to the proper business of the company and in violation of statute law. If it were held to be incidental to the business of the company and not a diminution of its capital, there seems to be no reason why "James Schofield & Sons Limited" should not have purchased at par a half or two-thirds, instead of a fourth, of its own shares' (430).



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