CORPORATE GIFTS AND ULTRA VIRES - A RETURN TO MUDDIED WATERS?

Brady v. *Brady*[1]

Introduction

THE decision of the English Court of Appeal in *Rolled Steel Products (Holdings) Ltd.* v. *British Steel Corporation*[2] was welcomed by many as one clearing up the confusion surrounding the meaning of *ultra vires* at common law. The object of this note is to determine what is left of that landmark decision after the decisions of the Court of Appeal[3] and the House of Lords in *Brady* v. *Brady.*

The Facts

The case arose out of a quarrel between two brothers who jointly owned a family company ("Brady Ltd.") which together with its subsidiaries carried on a haulage and drinks business. The "animosity and mutual intransigence" resulted in a deadlock in management which would clearly have been destructive of the potentially successful business.

To avert the threatening disaster, it was decided to split the business between the two brothers - one taking the haulage business and the other, the drinks business. However, to achieve equality between the brothers, a substantial movement of assets from the haulage to the drinks side was necessary. It was decided that this was to be accomplished through a highly complex restructuring which when reduced to its essentials involved the following:

(a) a company ("Motoreal") which would eventually be owned by one of the brothers acquired the share capital of Brady Ltd. for loan stock;

(b) Motoreal then redeemed the loan stock it had issued by arranging for Brady Ltd. to transfer to the holder of the loan stock one half of Brady Ltd.' s assets thus leaving Motoreal indebted to Brady Ltd.

One of the brothers became dissatisfied with the terms of the arrangement and sought to attack the transfer of assets by Brady Ltd. in redemption of the loan stock issued by its new parent company on two main grounds, namely:

1 [1988] 2 All E.R. 617.
2 [1985] 3 All E.R. 52.
3 [1987] 3 B.C.C. 535.

1. that it was a contravention of what is now section 151 of the Companies Act 1985, and
2. that it was a gratuitous transfer which was *ultra vires* Brady Ltd.

The Issues

1. *The financial assistance issue*

It is unlawful under section 151 of the Companies Act 1985 for a company to give financial assistance for the acquisition of its own shares or for the discharge of a liability incurred for the purpose of such an acquisition. There are however, significant exceptions which allow for such financial assistance if the acquisition of the shares or the discharge of the liability is not the principal purpose or if the giving of the assistance or the discharge of the liability "is but an incidental part of some larger purpose of the company", and in both instances, if the assistance is given "in good faith in the interests of the company".[4]

The transfer of assets admittedly involved giving financial assistance within section 151, but it was contended by the plaintiffs that it fell within the exemption in section 153(2) mentioned above.

2. *The ultra vires issue*

The defendants' contention was that when properly analysed, the consideration for the transfer in the form of the indebtedness of Motoreal to Brady Ltd. was merely a sham which produces an illusory result and masks what is in its essentials, nothing more than an out and out gift of Brady Ltd.'s assets to Motoreal. This was because Motoreal's financial position was such that it had no liabilities other than its indebtedness to Brady Ltd. and no assets other than the shares it held in Brady Ltd., its wholly-owned subsidiary. Motoreal therefore, it was contended, had no funds out of which it could possibly have discharged the indebtedness. Thus the promise was illusory and valueless.

The Decision

1. *The financial assistance issue*

At the Court of Appeal, none of the judges had any hesitation in finding the first part of section 153(2) satisfied. Croom-Johnson L.J. and Nourse L.J. agreed that the transfers were "but an incidental part of some larger purpose of the company", the larger purpose being Brady Ltd. keeping itself alive. O'Connor L.J. took the view that Brady Ltd.'s principal purpose in transferring its assets was not to help Motoreal acquire its shares but to avoid liquidation. But, if necessary, he too would have held that the assistance was "but an incidental part of some larger purpose" of Brady Ltd.

[4] Section 153(1) and (2).

However, in the judgement of O'Connor L.J. and Nourse L.J., the transfer failed to satisfy the requirement of paragraph (b) of section 153(2) that "the assistance is given in good faith in the interests of the company". There was no question as to lack of good faith, but the two judges, for different reasons, concluded that the assistance was not given "in the interests of the company".[5] O'Connor L.J. held that it could not be in the interests of the company to do something which would lay the directors authorising the transaction open to a charge of misfeasance.[6]

Nourse L.J., though doubtful whether misfeasance had been made out, held that the directors had failed to act in the interests of Brady Ltd. because they had not considered the interests of creditors, whose interests represent the interests of the company where the company is insolvent or doubtfully solvent or where the proportion of assets being removed is so large as to make consideration of their interests necessary, as in this case. Thus, as they had not given any consideration at all to the interests of the creditors, they could not have considered that the dispositions were in the interests of the company.

Nourse L.J.'s reasoning is, it is submitted, muddled. Although accepting that the test is subjective, he insists, in the same breath,[7] that the test remains twofold and then goes on to judge the fulfillment thereof by reference to what the court, and not the directors, considers is in the interests of the company.

At the House of Lords, their Lordships rejected any suggestion of misfeasance and made it clear that the words "in good faith in the interests of the company" formed a "single composite expression" and postulated a subjective test, which was, on the facts, satisfied.

However, as regards the interpretation of the words " larger purpose", their Lordships considered that the words must be given a narrower meaning if they are not to "provide a blank cheque for avoiding the effective application of section 151 in every case". Thus, they held that "larger" is not the same thing as "more important" nor "reason" the same as "purpose", and found that the purpose of the reorganisation was to give one brother control of Brady Ltd. The breaking of the deadlock and avoidance of liquidation was not the purpose, nor a larger purpose but the reason behind the scheme.[8]

Although it is felt that their Lordships' exercise in semantics results in a regrettably narrow interpretation of 'larger purpose' and deprives section 153(2) of the ability to give recognition to the often commercially necessary or advantageous objectives (as far as the company is concerned) behind many

5 Croom-Johnson L.J. held that the transfer did satisfy this test.
6 O'Connor L.J. reasoned that the transaction was in fact a massive gift to one of the brothers and thus misfeasance because in the event of liquidation, the liquidator could recover the assets from the donee and/or the directors.
7 [1987]3B.C.C. 535 at p. 552.
8 The appeal was ultimately allowed by the House of Lords which permitted the appellants to raise fresh argument based on the exemptions for private companies under sections 155-158.

financial assistance schemes,[9] it is not the objective of this note to discuss at length the financial assistance issue because of its limited relevance to Singapore where similar exemptions[10] are absent.

2. *The ultra vires issue*

The contention that the consideration for the transfer was illusory and valueless was taken hook, line and sinker by the entire Court of Appeal. Croom-Johnson L.J. (dissenting), the only judge who gave any consideration to the issue of whether the transfer was gratuitous, held that the transfer was a gratuitous transfer because the indebtedness of Motoreal to Brady Ltd. was "worthless" and "could never be paid" for "Motoreal had no money with which to pay it."[11] Nor did the judge accept as consideration the benefit to Brady Ltd. of the survival of its business. Nourse L.J. (with whom O'Connor L.J. concurred on the *ultra vires* issue) assumed without discussion or consideration of any other possibility, that the transfer of Brady Ltd.'s assets was a gratuitous transfer.

Accepting that the transfer was gratuitous, was it *ultra vires* Brady Ltd.?

Brady Ltd.'s memorandum contained, *inter alia,* the following object clauses:

Sub-clause 3(h) which read:

"To improve, manage, cultivate, develop, exchange, let on lease or otherwise mortgage, charge, sell, dispose of, turn into account, grantt rights and privileges in respect of or otherwise deal with all or any part of the property and rights of the company";

Sub-clause 3(u) which read:

"To sell or otherwise dispose of the whole or any part of the business or property of the company either together or in portions for such consideration as the company may think fit, and in particular, for shares, debentures or securities of any company purchasing the same". There was also the customary independent objects clause.

Whilst sub-clause 3(u) expressly required consideration moving to Brady Ltd., it was the appellants' contention that sub-clause 3(h) did not and accordingly, that even if the transfer constituted, on analysis, a gratuitous transfer by Brady Ltd., it was nevertheless *intra vires* because it was expressly authorised by sub-clause 3(h).

[9] As an example, see their Lordships postulation of the case of a bidder for a public company who finances the bid out of the company's funds. The only purpose of the financial assistance according to their Lordships, would be the acquisition of control of the company; the advantages to be gained from the acquisition, for example, more profitable management under the bidder's control, would form the reasons for making the bid, and not an independent larger purpose of which the financial assistance would be an incident.

[10] See Section 76, Companies Act, Cap. 50, 1988 (rev. Ed.).

[11] *Ante,* note 3 at p. 547.

Croom-Johnson L.J., relying heavily on *Re Horseley & Weight Ltd.,* held that distributing of assets was within sub-clause 3(h) which did not require consideration and which was a substantive object, subject to no express or implied limitation that it extended only to acts which benefit or promote the prosperity of the company.[12] The transfers were therefore *intra vires* the company.

The majority however held that sub-clause 3(h) did not allow for gratuitous dispositions and the transfers were accordingly *ultra vires* Brady Ltd.

The House of Lords unanimously decided that the transfer was *intra vires* Brady Ltd., not on the basis that its objects clauses permitted gratuitous dispositions but because it was not a gratuitous disposition in the first place.

The contention that the debt was illusory and a sham because Motoreal had no assets with which to discharge the debt to Brady Ltd. was rejected on the ground that although raising of the money required to discharge the debt by way of a sale by Motoreal of its shares in Brady Ltd. or by raising a loan on the security of the same was an expedient unlikely to be resorted to except in the most compulsive circumstances, it did not mean that Motoreal had no assets with which the debt could be paid if the need arose. Not satisfied with establishing the possibility (perhaps because it was recognised that the possibility was more theoretical than real) of the debt being paid, their Lordships went on to state categorically as a matter of principle, that there was "no rule of law which prohibits a parent company from borrowing from its subsidiary simply because it has no assets other than its holding of shares in the lender subsidiary."[13] It does seem only logical that as a promise by a parent company is in principle an acceptable consideration, it does not cease to be so merely because the parent company has at the date of the promise no other assets than the shares it holds in the promisee.

It having been determined that there existed consideration, the adequacy of the consideration was dismissed as not a matter relevant to the issue of *ultra vires.*

> "At the present stage, we are concerned only with the argument that the transfer will be *ultra vires* Brady … and not with its wisdom or propriety as an exercise of the directors' powers, which is an entirely different question … the fact that it may be only barely equal in value to what is disposed of or that it may prove, in certain circumstances, to be irrecoverable in whole or in part, does not turn the transaction into a transaction for which there is no consideration or render it otherwise *ultra vires."*[14]

Commentary

The unhappiness that this note seeks to express is not with the finding of the Court of Appeal that the transfer was gratuitous but with the finding of the majority of

[12] Even if such a limitation were to be implied, Croom-Johnson L.J. was of the opinion that the transfers would in any event benefit Brady Ltd.
[13] *Ante,* note 1 at p. 630.
[14] *Supra,* note 13.

that court that the gratuitous transfer was not authorised by the memorandum. The effect of that decision, it is submitted, is to return us to the muddied waters that existed before the *Rolled Steel Products* case.

The early attitude of the English judges towards corporate gifts and gratuitous transactions where the company receives no or no adequate compensation was one of general hostility, reflected in declarations like that of Bowen L.J. in *Hutton* v. *West Cork Railway Co.*[15] that there should be "no cakes and ale except such as are required for the benefit of the company" and that "charity has no business to sit at boards of directors *qua* charity". Company law was also for a long time perplexed by the dictum of Eve J. in *Re Lee, Behrens & Co. Ltd.*[16] that company dispositions must always pass three tests, namely: (a) it must be incidental to the carrying on of the company' s business, (b) it must be *bonafide* and (c) it must be done for the benefit of and to promote the prosperity of the company, and that these tests applied "whether they be made under an express or implied power."[17]

There began a change of heart when these tests, appropriate to implied powers and directors' duties and not express powers, were rejected in *Charterbridge Corporation Ltd.* v. *Lloyds Bank Ltd.*[18] There, Pennyquick J. was of the opinion that where a transaction was expressly authorised, that was the end of the matter. This change of heart was taken a step further by the Court of Appeal in *Re Horseley & Weight Ltd.*[19] where Buckley L.J. in his oft-cited statement, said that "the objects of a company do not need to be commercial, they can be charitable or philanthropic", and that there was "no reason why a company should not part with its funds gratuitously or for non-commercial reasons if to do so is within its declared objects".[20] Although this decision was an important turning point in the development of the law, it was deficient in that it retained the distinction between substantive objects and ancillary powers, re-introduced by the Court of Appeal in *Re Introductions Ltd.*[21] While the *Re Lee, Behrens* tests were held to be inapplicable to substantive objects, it appeared that in relation to ancillary powers, they were still to be relevant. On the facts there, it was held that a pension policy for a director was not *ultra vires* as there was an express provision to grant pensions which constituted a substantive object and not merely an ancillary power. The benefit and prosperity of the company were therefore immaterial.

This last snag in the development of the law was removed when the Court of Appeal in the *Rolled Steel Products* case established that a distinction was to be drawn between an act which is *ultra vires* the company and one which is in excess or an abuse of the powers of the directors of the company, the latter transaction merely rendering the transaction voidable in certain circumstances, but not void. Determining whether a transaction is *ultra vires* is a matter of construction of the object clauses in the company's memorandum of association.

15 (1883) 23 Ch. D 654.
16 [1932] 2 Ch. 46.
17 *Supra,* note 16 at p. 51.
18 [1970] Ch. 62.
19 [1982] Ch. 442.
20 *Supra,* note 19 at p. 450.
21 [1970] Ch. 199.

Although each provision of the memorandum is to be given its full effect, a particular provision might by its very nature be incapable of constituting a substantive object or its wording might indicate that it was only intended to constitude a power ancillary to the other objects. However, even where a particular transaction was only capable of being performed as something reasonably incidental to the attainment or pursuit of the company's objects, it will not be rendered *ultra vires* merely because the directors entered into it for purposes other than those set out in the memorandum. The transaction would be binding on the company on the basis of the apparent authority of the directors to bind the company unless the other party had notice of the directors exceeding their authority. The distinction between objects and 'mere' or ancillary powers, though still relevant to the agency issue had thus become irrelevant for the purposes of determining whether a transaction was *ultra vires.*

On the facts there, the Court of Appeal held that a guarantee which had been given for purposes not authorised by Rolled Steel Products' memorandum was, although an abuse of powers by its directors, nonetheless *intra vires* the company as its memorandum contained an ancillary power to give guarantees.

Thus, by the time *Brady* \. *Brady* came before the Court of Appeal, the "benefit of the company" tests in *Re Lee Behrens & Co. Ltd.* had been many times doubted and finally (or so it seemed) laid to rest by the Court of Appeal in the *Rolled Steel Products* case. It had also been quite firmly established that the question of capacity of a company depended on the true construction of its memorandum.

Returning to *Brady* v. *Brady,* was there not an objects clause allowing for gratuitous transfers? Did the transfer not fall within sub-clause 3(h), purely as a matter of construction? Even if sub-clause 3(h) were construed as an ancillary power as opposed to a substantive object, does the transaction not continue to be *intra vires* so long as it falls within the true construction of the said clause, notwithstanding that the directors might have entered into it for unauthorised purposes?

If the answer to all the above questions is in the affirmative, why then was the transfer held to be *ultra vires* Brady Ltd.? Was the Court of Appeal in so holding, returning us to the muddied waters before the *Rolled Steel Products* case.

On the face of Nourse L.J. 's judgement, he appears to heed the *Rolled Steel Products* rule of construction. His decision is in fact arrived at *via* a construction of the object clauses in Brady Ltd. 's memorandum of association but, with a vital difference – he subjects the interpretation of the object clauses to a statement made by Pennyquick J. in *Ridge Securities Ltd.* v. *I.R. Commissioners.*[22] He quotes as follows:

> *"A company can only lawfully deal with it assets in furtherance of its objects.* The corporators may take assets out of the company by way of dividend or, with leave of the court, by way of reduction of capital or in a winding-up.

[22] [1964] 1 All E.R. 275.

> They may, of course, require them for full consideration. They cannot take assets out of the company by way of voluntary disposition, however described, and, if they attempt to do so, the disposition is *ultra vires* the company."[23]

The case of *Ridge Securities Ltd.* v. *I.R. Commissioners* was, as the name suggests, a tax case. There, Pennyquick J. had given leave to the I.R. Commissioners to raise the contention, not raised before the Special Commissioners, that certain so-called interest payments were *ultra vires* the companies which made them. Pennyquick J. after concluding that the so-called interest payments represented in fact gratuitous dispositions in favour of the taxpayer company, accepted that, "on these facts and *in the absence offurther material,* it seems to me to follow that it was not within the powers of the company to enter into the covenant or to make the payments."[24] Reference was also made to the *Re Lee, Behrens & Co. Ltd.* tests, which Pennyquick J. accepted and applied without comment.

It is noted that the court was not there dealing with any express power and as Pennyquick J. himself pointed out, he was not asked to look at any memorandum of association nor was any application made by the taxpayer company (recipient of the payments) for remission of the case to the Special Commissioners in order that further evidence on this new point might be adduced. Under the circumstances, it was agreed by Pennyquick J. that his finding on the *ultra vires* issue would not bind the companies making the payments.

In the light of the above, the passage so heavily relied on and which formed the basis of Nourse L.J.'s decision, must surely be weak authority especially where there exists an express power. In any event, that passage must surely have been overruled by the subsequent cases of *Charterbridge Corpn. Ltd.* v. *Lloyds Bank Ltd.* (a decision by Pennyquick J. four years later, this time with *ultra vires* being more significantly in issue and the learned judge having the opportunity of examining the memorandum of association in question), *Re Horseley & Weight Ltd.* and the *Rolled Steel Products* case.

Having quoted the principle, Nourse L.J. says,

> "In its broadest terms the principle is that a company cannot give away its assets … in the realm of theory, a memorandum of association may authorise a company to give away all its assets to whomsoever it pleases, including its shareholders. But in the real world of trading companies – charitable or political donations, pensions to widows of ex-employees and the like apart – it is obvious that such a power would never be taken."[25]

Applying that principle, he comes to the conclusion that "the principle requires us to start with no predisposition to construe the memorandum of association... so as to authorise gratuitous dispositions of their assets"[26] and thus he concludes that sub-clause 3(h) does not allow for gratuitous dealings.

[23] *Ante,* note 3 at p. 550 (emphasis my own).
[24] *Ante,* note 22 at p. 288 (emphasis my own).
[25] *Ante,* note 23.
[26] *Ante,* note 23.

Nourse L.J.'s decision is thus reached through construing sub-clause 3(h) but in the course of which he subjects the clause to a principle of highly questionable authority and from which is spawned equally questionable conclusions. But all this, it is submitted, is but a poor disguise for a return to the muddied waters before the *Rolled Steel Products* case when words (in the memorandum) do not necessarily mean what they say and 'benefit of the company' the yardstick for validating dispositions.

The decision itself might be distinguishable on the basis that sub-clause 3(h) was ambiguous and was in fact properly construed as not including amongst its permissible transactions, gratuitous dispositions. The present unhappiness with the judgement however, is not with the end result but with the means by which it was reached. Indeed, it has been pointed out that the same result could have been reached using the principle that birds of a feather flock together.[27] Though the words 'dispose of are wide enough in themselves to include a disposition for no consideration, those words would probably take their colour from their context and be restricted to dispositions for value.

It is regrettable therefore that instead of relying on more tried and accepted principles of interpretation, Nourse L.J. chose to rely on and himself author broad principles which cast doubt on the ability of a company, even in the presence of express powers, to make gratuitous dispositions (charitable or political donations, pensions and the like apart)!

Because of their finding that the transfer was supported by consideration, there was no need for their Lordships to, nor did they, examine sub-clause 3(h) or express an opinion on the issue of gratuitous dispositions. There was in the judgement of their Lordships delivered by Lord Oliver of Aylmerton, no mention of the *Rolled Steel Products* case or *Re Horseley & Weight Ltd.* or any of the cases relating to gratuitous dispositions.

It is unfortunate that the House of Lords did not undo the damage inflicted by Nourse L.J. on the *ultra vires* doctrine, and chose instead, not to take a stand on the issue nor to throw its weight behind a principle that had taken fifteen years to mature.

Conclusion

Nourse L.J.'s judgement proves so true the old adage that old habits die hard. It was only two decades ago that English judges assumed virtually without question that the sole purpose of a company was to make profits for its shareholders. Even today, when there is greater support for the view that responsible companies should not neglect the wider interests of employees, customers and the community, the underlying assumption is still that the company's predominant purpose is profit-making, so that where the altruistic

[27] See Ford, *Principles of Company Law* (3rd ed.) para. 523, commenting on clause 21, schedule 2 of the Australian Uniform Companies Act which gives the power to "sell, improve, manage, develop, exchange, lease, dispose of, turn to account or otherwise deal with all or any part of the property and rights of the company".

gesture carries with it no corresponding benefit for the company in the form of improved public relations or otherwise, the tendency to disallow the same is often irresistable.

PATRICIA G. S. ONG-WEE*

* LL.B. (N.U.S.), LL.M. (Lond.), Lecturer, Division of Legal Studies and Taxation, School of Accountancy and Commerce, Nanyang Technological Institute.