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A CORPORATION'S PURCHASE OF ITS OWN SHARES

A RATIONALE OF THE RULE IN *TREVOR* v. *WHITWORTH*: A CANADIAN VIEW

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A CORPORATION'S PURCHASE OF ITS OWN SHARES

The Rationale of The Rule in Trevor v. Whitworth[1]

Any examination of the concept of a corporation purchasing its own shares must begin with an examination of the rule of English common law laid down by the House of Lords in Trevor v. Whitworth prohibiting such a purchase. In that case a company, whose objects were to carry on a flannel manufacturing business and any other business and transactions which the company might consider to be in any way conducive or auxiliary thereto, had in its articles a provision empowering it to utilize its funds to purchase its own shares. The company having gone into liquidation, a former shareholder made a claim against the liquidator for the balance of the purchase price of the company's shares sold by him to the company before the liquidation.

The House of Lords[2] held that the company had no power to purchase its own shares and that that portion of the purchase price already paid by the company had to be returned. The purchase transaction was held void on two grounds:

1) the narrower ground that the objects of the company as provided by its memorandum did not include the power to purchase the company's own shares and the transaction was therefore *ultra vires*, and

2) even if the purchase was *intra vires* the company, such a power is void as being contrary to both the provisions and the principles of the Companies Act.[3]

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[1] (1887) 12 A.C. 409 (House of Lords).

[2] Comprising Lords Herschell, Watson, Fitzgerald and Macnaghten.

[3] The Companies Act (U.K.), 1877.

An examination of the judgments in Trevor v. Whitworth and the later cases which followed or considered it discloses that the principle rationale for the rule prohibiting a corporation's purchase of its own shares is the protection of the creditors of the corporation who are entitled to rely on its paid-up capital as a source of funds to which they can look for payment. The capital of a corporation may be diminished or lost by expenditures made in the cause of carrying on its business and this is a risk that both shareholders and creditors must bear, but it would be prejudicial to creditors and their protection would be illusory if the company's assets could be freely distributed to its members. Lord Herschell stated:[4]

> What is the meaning of the distinction thus drawn between a company without limit on the liability of its members and a company where the liability is limited, but, in the latter case, to assure that those dealing with the company that the whole of the subscribed capital, unless diminished by expenditure upon the objects defined by the memorandum, shall remain available for the discharge of its liabilities? The capital may, no doubt, be diminished by expenditure upon and reasonably incidental to all of the objects specified. A part of it may be lost in carrying on the business operations authorized. Of this all persons trusting the company are aware, and take the risk. But I think they have a right to rely, and were intended by the Legislature to have a right to rely, on the capital remaining undiminished by any expenditure outside these limits, or by the return of any part of it to the shareholders.

Lord Macnaghten stated:[5]

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[4] Trevor v. Whitworth (1887) 12 A.C. 409 at 415.

[5] Id. at 432.

> The third point is one of general importance. It raises the question whether it is competent for a company..., on the principle of limited liability, to purchase its own shares when it is authorized by its articles to do so. The consideration of that question, as it appears to me, necessarily involves the broader question whether it is competent for a limited company under any circumstances to invest any portion of its capital in the purchase of a share of its own capital stock, or to return any portion of its capital to any shareholder without following the course which Parliament has prescribed.

And further:[6]

> "...they cannot draw on a fund in which others as well as themselves are interested. That, I think, is the law, and that is the good sense of the matter."

It is clear therefore that the thrust of the rule in Trevor v. Whitworth is that as a consequence of being able to operate under the privilege of limited liability, the corporation is under no obligation to return any of its paid-up capital to its shareholders during its existence,[7] nor can it legally do so otherwise than as provided by the statute to which it owes its existence.[8] To the creditors

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[6] Id. at 436.

[7] Campbell v. Prudential Trust Company Limited and Superintendent of Brokers [1944] 3 W.W.R. 456 (B.C.C.A.).

[8] For Alberta companies, in accordance with the procedures and for the purpose set out in sections 38 to 41 of the Companies Act, R.S.A. 1970, c. 60.

of a corporation, for whose benefit the rule was primarily established, the object or purpose for which a corporation has purchased its own shares makes no difference. The result to them is the same, namely that the shareholders receive back the monies subscribed and there passes into their pockets what before existed in the form of cash, or of buildings, machinery or other assets available to meet his demands. The rule applies even where the company is expressly empowered by its articles to purchase its own shares, such a provision being void[9] since "neither the memorandum nor the articles can confer greater powers than the Act under which the company is incorporated."[10] More importantly, the prohibition has been held to apply regardless of whether the company is solvent at the time of the purchase of its own shares, with the result that creditors may not be prejudiced, on the basis that where a statute "sanctions the doing of a thing under certain conditions, it must be taken that the thing is prohibited unless the prescribed conditions and restrictions are observed."[11]

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[9] Trevor v. Whitworth; Re Fish and Game League (Regina) (1967) 630 D.L.R. (2d) 47 (Sask. Q.B.).

[10] Per Clarry, M.C. in Inre The Walbridge Grain Company Ltd. [1918] 2 W.W.R. 886 (Alta. S.C.), affirmed [1918] 2 W.W.R. 890 (Alta. S.C.A.D.). Article 6 of Table A of the Companies Act provides: "6. No part of the funds of the Company shall be employed in the purchase of, or in loans upon the security of, the Company's shares."

[11] Trevor v. Whitworth (1887) 12 A.C. 409 at 437 (per Lord Macnaghten). It is interesting, however, to note the reluctance following the rule in such a situation evidenced by the statement of Hyndman, J. in In Re The Walbridge Grain Company Ltd., supra, n. 8 at 892: "As the parties affected were acting in the utmost good faith and all the debts of the company were fully paid it is with some reluctance that I dismiss the appeal!"

In addition to the protection of creditors, Lord Macnaghten provided a subsidiary reason for the prohibition against a corporation purchasing its own shares in answering the argument that the power to purchase shares might be validly exercised as an incident of domestic management to buy out shareholders whose continuance was undesirable:[12]

> Is it possible to suggest anything more dangerous to the welfare of companies and to the security of their creditors than such a doctrine? Who are the shareholders whose continuance in a company the company or its executive consider undesirable? Why, shareholders who quarrel with the policy of the board, and wish to turn the directors out; shareholders who ask questions which it may not be convenient to answer; shareholders who want information which the directors think it prudent to withhold. Can it be contended that when the policy of directors is assailed, they may spend the capital of the company in keeping themselves in power, or in purchasing the retirement of inquisitive and troublesome critics?

Thus, the rule in Trevor v. Whitworth also provides a basis for protection of the shareholders of a company itself, especially those in a minority position, since the prohibition of a company's purchase of its own shares prevents the directors from authorizing a purchase in order to maintain control, remove a troublesome shareholder, restrict membership in the company,[13] or otherwise reduce capital by the issue of fully paid-up shares at a discount to certain

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[12] Trevor v. Whitworth (1887) 12 S.C. 409 at 435.

[13] Re Fish and Game League (Regina) (1967) 63 D.L.R. (2d) 471 (Sask. Q.B.).

shareholders,[14] or the release of certain shareholders from their liability for uncalled capital.

Gower[15] provides that a corporation's purchase of its own shares is dangerous, not only because it might result in a reduction of the capital yardstick of the corporation to the detriment of creditors, but also because, if the company paid more than the true worth of the shares, it would dilute the value of the remainder, while if it paid too little it would increase the value of the remainder and might be used by the directors to enhance their own holdings. Moreover such purchases might be used by the directors to maintain themselves in control, for example, by using the company's funds to purchase its own shares on the market in an effort to frustrate a potential take-over bid.

Charlesworth's[16] provides that the capital of a company may be lost or diminished according to the fluctuations of the business, but otherwise it cannot be reduced without the sanction of the court. The object is twofold-- (1) to protect persons dealing with the company, so that the fund available for satisfying their claims shall not be diminished except by ordinary business risks; and (2) to ensure that the reduction is equitable as between the shareholders of the company. In effect, the prohibition prevents the possibility of the directors of a company from showing a preference to one shareholder or group of shareholders (which may or may not include one or more of the directors themselves) by having the company purchase only their shares.

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[14] Oregum Gold Mining Co. of India Ltd. v. Roper [1892] A.C. 125 (H.L.); the issuance of fully paid-up shares at a discount is prohibited in Alberta under the Companies Act, R.S.A. 1970, c. 60, s. 114(2).

[15] Gower, L.C.B., The Principles of Modern Company Law, (3d. ed.), London, Stevens & Sons, (1969) at 112.

[16] Charlesworth's Company Law (9th ed.) edited by T. E. Cain, London, Stevens & Sons, (1968) at 144.

Gore-Browne[17] provides that the rule in Trevor v. Whitworth has the dual purpose of maintenance of capital for the protection of creditors and prevention of the directors strengthening their position in the company through their use of voting rights attached to shares purchased and held by the company. Pennington[18] adds that the rule preventing a corporation from purchasing its own shares is part of the larger rule preventing an unauthorized reduction of the issued capital of a corporation which is designed to ensure that creditors are not defrauded by the company's assets being distributed amongst its shareholders,

or by the company releasing its shareholders (often including the directors) from liability for uncalled capital, and to ensure that any reduction of capital is fair as between different classes of members of the corporation.

Gower[19] states that it was early recognized that the rigid application of this common law principle might be unduly strict. In particular, if a company had consistently made losses so that its net worth was hopelessly below the figure fixed by its capital, little purpose was served by maintaining the capital yardstick at its original figure--a figure no longer represented by assets to which creditors could look for payment. This was, however, very different from a repayment of the company's assets to its members in return for their shares, but even the latter might sometimes be for a legitimate business reason. If the company curtailed its activities so that its net assets were greater than it needed or could profitably employ, then, provided that

[17] Gore-Browne on Companies (42d. ed.) edited by A.J. Boyle, London, Jordon & Sons, (1972) at 278.

[18] Pennington, R., Company Law (3d. ed.), London, Butterworth's, (1973) at 160.

[19] Supra, n. 15 at 111-112.

creditors were provided for, it was pointless to refuse to allow it to make a repayment to its members in reduction of the issued capital. Thus the strict application of the common law rule was altered by statute which provided that issued capital might be reduced subject to certain safeguards and to the consent of the court. In Alberta, sections 38 to 41 of the Companies Act[20] allow a company to reduce its share capital for the following purposes:[21]

> 38.(1) A company having a share capital by special resolution confirmed by an order of the court,
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> (b) may alter its memorandum so as to reduce its share capital in any way, and without prejudice to the generality of the foregoing power may modify or alter its memorandum so as to
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> (i) extinguish or reduce the liability on any of its shares in respect of share capital not paid up, or
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> (ii) either with or without extinguishing or reducing liability on any of its shares, cancel any paid-up share capital that is lost or unrepresented by available assets, or
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> (iii) either with or without extinguishing or reducing liability on any of its shares, pay off any paid-up share capital that is in excess of the wants of the company.

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[20] R.S.A. 1970, c. 60.

[21] Para. 38(1)(b).

The prohibition against a company purchasing its own shares is primarily based on the prejudice to creditors that arises because such a purchase involves the paying out of assets (in the form of cash or otherwise) of the company to its members. Thus, where a company receives its own fully paid-up shares in a transaction which does not require the company to pay any assets to the shareholder, the transaction will not be void since it does not involve an unathorized reduction of share capital.

For example, an exchange of fully paid-up shares for others of a like par value[22] or a surrender of fully paid-up shares does not constitute a violation of the rule. In Zwicker v. Stanbury, Cartwright, J. (as he then was) stated:[23]

> Such surrender is in no sense a purchase by the Company of its own shares as it involves neither payment by the Company nor (the shares being fully paid up) the release by the Company of any liability to it. No reduction in capital is brought about as the company parts with nothing and its authorized capital will remain unaltered, although the number of issued shares will be reduced and the number of unissued shares will be correspondingly increased.

A shareholder may bequeath[24] or transfer[25] fully paid-up shares to the company or to a trustee for the company, provided that the company provides no consideration for such bequeath or transfer.

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[22] Rowell v. John Rowell & Sons Ltd. [1912] 2 Ch. 609.

[23] [1954] 1 D.L.R. 257 (S.C.C.) at 270-271.

[24] Re Castiglione's Will Trusts [1958] Ch. 549.

[25] Kirby v. Wilkins [1929] 2 Ch. 444; Moore v. Northwood (1960) 22 D.L.R. (2d) 698 (Man. C.A.).

A surrender or forfeiture of partly-paid shares presents a different situation since presumably the result of such surrender or forfeiture is to release the shareholder from any further liability with respect to the shares, thereby constituting a reduction of capital. The Law Lords in Trevor v. Whitworth did not make a distinction as to whether the shares surrendered or forfeited were fully paid up or not in stating that any forfeiture or surrender is not prohibited since it did not require the corporation to pay out any assets in return for the shares.[26] Gower[27] explains that Trevor v. Whitworth stands for the proposition that a company may accept a surrender of partly paid shares to avoid the formalities of forfeiture.[28] Gore-Browne[29] provides that Court confirmation of a reduction of capital under section 66 of the English Companies Act, 1948 is not required where a company has an express power in its articles to accept forfeited shares and either cancel or reissue them.[30] The rationale for such a provision is based on the premise that creditors who grant credit to a corporation are not prejudiced if they are cognizant of the fact that a portion of the issued capital is not fully paid and the corporation has the power in its articles to accept a forfeiture of shares not fully paid--or, alternatively, that the creditors are only entitled

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[26] See, for example (1887) 12 A.C. 409 at 417-418 (per Lord Herschell).

[27] Supra, n. 15 at 114. This is substantiated in Bellerby v. Rowland and Marwood's S.S. Co. Ltd. [1902] 2 Ch. 14.

[28] Doubt as to the propriety of a general surrender of partly paid shares is also expressed by Cartwright, J. (as he then was) in Zwicker v. Stanbury [1954] 1 D.L.R. 257 at 271.

[29] Supra, n. 14 at 345.

[30] Such express provisions exist in the Alberta Companies Act, R.S.A. 1970, c. 60, Table A, art. 21-26.

to rely on the paid-up capital of the company as a source to look to for payment of their claims.[31]

The rule in Trevor v. Whitworth has also been held not to apply where shares issued by a corporation in return for an asset are returned and cancelled where the asset proves to be worthless to the corporation and the transferor is willing to take it back.[32] Such proposition was again based on the principle that the transaction whereby the company received its own shares did not involve the paying out of any of its assets since the asset re-transferred was worthless to the corporation. The proposition espoused by Macdonald, J. A., however, presents an interesting restriction of the application of the common law rule:[33]

> If, on the other hand, it is insisted that some value must be given to this asset, and if to the extent of that value the capital was incidentally diminished, it still does not follow that the transaction is void [under the rule in Trevor v. Whitworth]. Each case must be decided on its own facts and I apprehend that the dimunition in capital must not be fanciful or theoretical, but actual and substantial, before the transaction can be successfully attacked.

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[31] Paragraph 36(1)(3) of the Companies Act, R.S.A. 1970, c. 60 effectively provides that a company can only accept a surrender of full paid-up shares by way of gift and then only if its articles so provide. The problems raised by the concept of partly paid shares are beyond the scope of this paper and a discussion of such would bear little relevance in light of the Committee's decision to remove the concept from Alberta company law.

[32] British Columbia Red Cedar Shingle Co. Ltd. v. Stoltze Manufacturing Co. Ltd. [1932] 1 W.W.R. 164 (B.C.C.A.).

[33] Id. at 172-173. See also on a similar point the earlier case of Wheeler and Wilson Manufacturing Co. (1885) 6 O.R. 421.

The prohibition against a corporation purchasing its own shares has been held, in Canada, not to apply to the provision of financial assistance by the corporation for the purchase of its own shares.[34] In Mt. View Charolais Ranch Ltd.; Lynch v. Haverland, Prouse, J. A., after reviewing the decisions of the various Law Lords in Trevor v. Whitworth, stated:[35]

> It will be noted that in the above judgments a distinction was drawn between the impairment of the capital structure of a company that flows from a purchase of its own shares and the impairment of the financial position of a company when it enters into a transaction reasonably incidental to its objects which turns out unfavourably from the company's point of view. In other words the basic objection to a purchase by a company of its own shares was that it effected a reduction of capital in a manner not authorized by the Companies Act.
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> I have considered a number of cases in which Trevor v. Whitworth has been considered as applied and they dealt generally with the extension of the principle therein enunciated to cases dealing with forfeiture of shares other than in accordance with the statutory requirements, selling of shares at a discount and like transactions that effected a reduction of capital of the company.

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[34] Hughes v. The Northern Electric and Manufacturing Company (1914) 50 S.C.R. 626; Mt. View Charolais Ranch Ltd.; Lynch v. Haverland [1974] 2 W.W.R. 289 (Alta. S.C.A.D.); but contra Murray and Murray v. C. W. Boon & Company Ltd. [1974] 2 W.W.R. 620 (Alta. D.C.). Section 14 of the Alberta Companies Act, however, prohibits a public company from providing such assistance. In England, section 54 of the Companies Act, 1948 purports to prohibit all companies from providing financial assistance. It has been criticized as having prejudiced the innocent but failing to deter the guilty.

[35] [1974] 2 W.W.R. 289 (Alta. S.C.A.D.) at 296-297.

Berner[36] suggests that there has been an increasing tendency of the courts to restrict the effect of the well-established rule in Trevor v. Whitworth and cites Mt. View Charolais Ranch Ltd; Lynch v. Haverland as an example.

The Jenkins Committee provided:[37]

> "We do not think that the practice whereby a company provides financial assistance for the acquisition of its own shares necessarily offends against the rule that a limited company may not buy its own shares ...The reason why a limited company may not buy its own shares is that in doing so it would part outright with the consideration for the purchase and thereby reduce its capital. A company which lends money to a person to buy its shares simply changes the form of its assets and if the borrower is able to repay the loan the company's capital remains intact."

They accordingly suggested that the provision of financial assistance should be permissible if the transaction was approved by a special resolution of the company and a declaration of the company's solvency after the transaction made and filed by the directors. They pointed out that these requirements would effectively prevent the possible prejudice of minority shareholders and creditors.[38]

Gower[39] submits that the provision by a company of financial assistance for the purchase or subscription of its shares is objectionable. He states that the common

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[36] Berner, S. H., "Annual Survey of Canadian Law: Corporation Law", [1975] 7 Ottawa L.R. 153 at 161.

[37] 1962, Cmmd. 1749, para. 173.

[38] Id. at paras. 177-186.

[39] Supra, n. 15 at 113.

practice of a take-over bidder to buy the shares in a company with large liquid assets and then using those assets to recoup the bridging loan he raised to initially pay for the shares can be prejudicial to both creditors and minority shareholders. He approves of the safeguards recommended by the Jenkins Committee but notes that as yet they have not been implemented.

The strict rule in Trevor v. Whitworth, namely that a company cannot purchase its own shares, has been relaxed to some extent by the provisions of the Alberta Companies Act:[40]

(1) As previously discussed, a company may purchase its own shares and thereby effect a reduction of share capital in accordance with the requirements and procedures set out in sections 38 to 41;

(2) the redemption of preference shares pursuant to section 70; and

(3) the redemption of mutual fund shares pursuant to section 71.

Section 69(1) allows a company to issue preferred shares expressly created as redeemable. The dangers of redemption, in effect a purchase by the company of its own shares since their value is unlikely to fluctuate much and they normally do not carry voting rights. Section 70 provides the requirements of their redemption and ensures that the capital yardstick is not reduced. They can be redeemed when fully paid[41] and only out of the proceeds of a fresh

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[40]R.S.A. 1970, c. 60.

[41]Section 79(2).

issue, in which case the capital of the new shares will replace the capital of those redeemed, or out of profits.[42] In the latter event an amount equivalent to the nominal amount of the shares redeemed[43] must be transferred to the "capital redemption reserve fund" and this has to be treated as if it were paid-up capital of the company.[44] Hence, although the shares redeemed disappear, the paid-up capital which they represent is retained for accounting purposes and there is no reduction of the capital yardstick.

Gower[45] in discussing a similar provision in the English Companies Act, states:

> The section is a recognition that it is possible to allow companies to buy their own shares without opening the door to abuse. The Jenkins Committee[46] considered whether, as in the U.S.A., there should be a general power for companies to buy their own shares. Although they recognized that the needful safeguards could be provided and would not be unduly complicated, they rejected this idea largely because there was no demand for it. This illustration of the conservatism of the English legal and commercial world is regrettable, since such a power would undoubtedly be useful to private companies and to all companies wishing to introduce employee share-ownership schemes and would enable unit trusts to operate as companies instead of through the more complicated medium of a trust.

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[42] Section 70(1).

[43] Any premium payable on redemption must be provided out of profits or a share premium account.

[44] Section 70(3).

[45] _Supra_, n. 15 at 114 from where the text of the explanation of the section was adopted.

Section 71 provides for an express exception in the case of "mutual fund shares". These are shares issued by a company whose only undertaking is the business of investing the funds of the company.[47] At the demand of the holder of such shares, the company shall accept a surrender of all of the shares or fractions or parts thereof as are fully paid and the price to be paid therefore may be paid out of the company's assets, including its capital.[48] Upon surrender, such shares are deemed to be no longer outstanding and cannot be reissued by the company.[49]

Summary and Conclusions

It has been shown that a limited company cannot purchase or receive any of its own shares pursuant to any transaction where in return for the shares it has paid or agreed to pay out assets, either in the form of cash or in the form of other valuable assets, for such payment constitutes an unauthorized reduction of the share capital of the company. Share capital can only be reduced in those restricted circumstances specifically provided for in the Alberta Companies Act.

The prohibition of a corporation's purchase or receipt of its own shares so as to constitute an unauthorized reduction of share capital is designed:

(1) for the protection of creditors who are entitled to rely on the maintenance of the paid-up capital of the company as a

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[47]Section 71(2).

[48]Section 71(4).

[49]Section 71(3).

source or guaranteed fund to look to for the payment of their claims;

(2) for the protection of both shareholders, especially those in the minority, and creditors by preventing the directors of a company from issuing fully paid-up shares at a discount, releasing certain shareholders from liability with respect to uncalled capital and for utilizing the corporation's fund to purchase its own shares in order to:

(i) retain control of the corporation, for example, by frustrating a threatenened take-over bid,

(ii) strengthen their own position in the corporation through their use of voting rights attached to the shares purchased and held by the company,

(iii) d lute the value of the remainder of the shares by paying too high a price or those purchased or enhancing the value of the remainder (including their own holdings) by paying too little,

(iv) confer a preferential benefit on certain shareholders by having only their shares purchased or purchased at preferential prices,

(v) remove any inquisitive or troublesome shareholder,

(vi) prevent the undermining of the cushion of protection created by dividends and capital in respect of preferred shareholders,[50] and

(vii) prevent rash speculation in the market by the directors;[51]

(3) for the protection of the investing public in general, as well as the smaller shareholders of large listed public companies, since there are obvious possibilities of manipulation of market prices. For example, insiders of such companies can cause the company to purchase its own shares on the market, thereby raising the price, and then sell their own shares at the higher price. Further, on the basis of "inside" information, the directors of the company would be in a position to take advantage of the uninformed seller when the company purchases his shares. Finally, the reacquisition of shares could give rise to deceptive accounting practices where, for example, the reacquired shares are not cancelled and remain listed on the company's balance sheet as part of its issued capital.

In light of these protective reasons for the rule in Trevor v. Whitworth, it is submitted that any legislation intending to grant to corporations the power to purchase their own shares should be carefully measured in terms of its preventative safeguards against such possible abuses.

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[50]Howard, J. L., "The Proposals for a New Business Corporations Act for Canada: Concepts and Policies", 1972 L.S.V.C. 17 at 43.

[51]*Id.*