[HIGH COURT OF AUSTRALIA.]

MITCHELL . . . . . APPELLANT;
DEFENDANT,

AND

HART AND OTHERS . . . . . RESPONDENTS.
DEFENDANTS AND PLAINTIFFS,

ON APPEAL FROM THE SUPREME COURT OF NEW SOUTH WALES.

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SYDNEY, *Sept.* 1; *Nov.* 26.

Griffith C.J., Isaacs and Gavan Duffy JJ.

Company—Increase of capital—Issue of new shares—Declaration of bonus—Payment for shares by bonus—Option to shareholders—Tenant for life and remaindermen—Capital or income.

Where a company increases its capital by issuing new shares which are offered to shareholders, and at the same time distributes accumulated profits in the form of a dividend or bonus with which payment may be made for the new shares so offered, the amount of a dividend or bonus in respect of shares held by trustees which is applied in payment for new shares offered to and accepted by them is, as between tenant for life and remaindermen, income of the estate and not capital, unless the ordinary instincts of human self-interest of a reasonably prudent man would naturally and instantly lead him to apply the dividend or bonus in payment of the new shares notwithstanding that acceptance of the shares is legally refusable.

A company increased its capital by issuing new shares which were offered to shareholders in proportion to the number of shares held by each and a bonus was at the same time declared out of accumulated profits equal to the full amount payable on the shares, which might be applied by shareholders in payment for the new shares, subject to a provision that the company might sell all shares not applied for by shareholders and distribute the amount of the premium obtained *pro ratâ* among the shareholders who did not apply for new shares. It was common ground that the value of the new shares would exceed the amount of the dividend.

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Held, by *Isaacs* and *Gavan Duffy* JJ. (*Griffith* C.J. dissenting), that from a business standpoint a full and free option was left to shareholders to accept or refuse new shares, and therefore that as between tenant for life and remaindermen, although new shares accepted by trustees were capital of the estate, the tenant for life was entitled to a charge on them for the amount of the bonus.

Decision of the Supreme Court of New South Wales (*Harvey* J.) affirmed.

APPEAL to the High Court from the Supreme Court of New South Wales.

By his will dated 5th December 1890 James Sutherland Mitchell, who died on 10th July 1893, after bequeathing certain legacies, devised and bequeathed the surplus of his real and personal estate to his trustees upon trust for his wife and his children who should attain the age of twenty-one years or marry, and as to his wife's share upon trust to pay the annual income thereof to her during her life with remainder to his children, and as to the share of each of his children upon trust to pay to him or her the yearly income thereof until the happening of certain events, and as to the capital and income thereof after the death of such child upon trust for the children of such child.

At the date of his death the testator was possessed of (*inter alia*) 56,058 fully paid £1 shares in Tooth & Co. Ltd., of which on 30th November 1910 the trustees had sold all but 14,000. The capital of the Company was then £900,000, consisting of 900,000 shares of £1 each. On 30th November 1910 the Company passed the following resolutions:—

"1. That the capital of the Company be increased from £900,000 to £1,000,000, by the creation of 100,000 new shares of £1 each, ranking for dividend and in all other respects *pari passu* with the existing shares in the Company.

"2. That such new shares be offered in the first instance to the shareholders at par in the proportion of one new share to every nine shares held by each shareholder on 31st December next, and upon the footing that the full amount of each share taken up shall be paid to the Company on the acceptance of the offer and that such offer be made by notice specifying the number of shares to which the shareholder is entitled, and limiting a time, to be

fixed by the Board, within which the offer if not accepted by payment will be deemed to be declined.

"3. That the sum of £100,000, being portion of the amount standing to the credit of the Company's reserves, be distributed amongst the shareholders by way of bonus in proportion to the number of shares held by them respectively on 31st December next, and that each shareholder may direct in writing that the amount of bonus due to him be used in payment for the new shares to which he shall become entitled under the preceding resolution, such shares to fully participate in any dividend that shall be declared in April 1911 in respect of profits which shall have accrued to 31st March 1911.

"4. That the directors be and are hereby authorized to dispose of any shares offered under the preceding resolutions and of which no notice of acceptance shall have been received by the secretary of the Company on or before the day appointed by the Board to such persons and upon such terms as the Board may deem most advantageous, and the premiums received from the sale of such shares—less expenses—shall be divided between the shareholders who have not exercised their right of application *pro ratâ* to the number of shares to which they would have been entitled had they made application for same.

"5. That any shares left unallotted by reason of certain holdings not being exactly divisible by nine, shall be disposed of by the directors, and the premiums received from the sale of such shares—less expenses—shall be divided proportionately amongst the shareholders entitled thereto according to their respective interests in the fractional parts."

Pursuant to these resolutions 1,555 new shares were offered to and accepted by the trustees, and paid for as provided by the resolutions. On 29th May 1912 similar resolutions were passed in respect of a further increase of the capital of the Company from £1,000,000 to £1,100,000, the bonus in this case being provided for out of the reserve for equalization of dividends. Pursuant to those resolutions 1,400 new shares were offered to and accepted by the trustees, and paid for accordingly.

An originating summons was taken out by the trustees, the Permanent Trustee Co. Ltd. and James Kidd, asking whether the

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bonuses, or shares paid for by such bonuses, or the proceeds of sale of such shares or fractional parts thereof, or any portion of such bonuses, shares or proceeds, received by the trustees were capital or income of the estate of the testator.

It appeared that at all material times the new shares were at a premium.

The originating summons was heard by *Harvey* J., who made an order declaring that the 1,555 new shares and the 1,400 new shares received by the trustees formed part of the capital of the estate, but that the tenants for life under the will were entitled to a charge on each of such shares respectively to the extent of £1, being the amount of the bonuses applied in payment of such shares respectively; and that the amount of the charge ought to be raised by a sale by the trustees of a number of the new shares sufficient to raise the amount of the charge.

From this decision Isabel Sutherland Mitchell, who represented the beneficiaries interested in the corpus of the estate, appealed to the High Court.

Langer Owen K.C. (with him *Bethune*), for the appellant. The substance of the transaction must be looked at, and the substance is a capitalization of profits; what is described as a dividend or bonus must be treated as capital: *Bouch* v. *Sproule* (1); *In re Northage*; *Ellis* v. *Barfield* (2); *In re Malam*; *Malam* v. *Hitchens* (3). The test is what was the intention of the directors as expressed by what they did: *In re Despard*; *Hancock* v. *Despard* (4); *In re Hume Nisbet's Settlement* (5); *In re Evans*; *Jones* v. *Evans* (6). Taking the scheme as a whole, the *primâ facie* object was to increase the capital of the Company.

[GRIFFITH C.J. We are dealing with the interpretation of a will, and the question is what did the testator mean by "income"? See *Irving* v. *Houston* (7).]

Knox K.C. (with him *E. Milner Stephen*), for the respondent Edith Maria Hart, representing the beneficiaries interested in the income of the estate. A distribution of profits lawfully made by

(1) 12 App. Cas., 385.
(2) 64 L.T., 625.
(3) (1894) 3 Ch., 578.
(4) 17 T.L.R., 478.
(5) 27 T.L.R., 461.
(6) (1913) 1 Ch., 23, at p. 32.
(7) 4 Paton, Sc. App., 521.

a company by way of dividend or bonus is to be treated as income unless it is shown to be something else: *Bouch* v. *Sproule* (1). Where the terms of the resolutions are such that it is the duty of trustees who held shares to take the new shares —which is the case where there is a substantial advantage to be gained by taking them—the new shares should be treated as corpus, and there may or may not be a charge upon them for the amount of the dividend or bonus in favour of the tenant for life. But if no advantage is to be gained by taking the new shares in preference to the cash dividend or bonus, the reasonable rule is that the dividend or bonus should be treated as income. [He also referred to *In re Piercy*; *Whitwham* v. *Piercy* (2); *In re Armitage*; *Armitage* v. *Garnett* (3); *In the Will of Woolcott*; *Woolcott* v. *Woolcott* (4).]

Langer Owen K.C., in reply.

Cur. adv. vult.

Nov. 26.

GRIFFITH C.J. read the following judgment:—The question for determination in this case is whether certain shares in Tooth & Co. Ltd., which were allotted to and accepted by the trustees of the testator's will, are under the circumstances to be regarded, as between the persons entitled to the income of the testator's estate and those entitled in remainder, as an accretion to capital or as income. The learned Judge, following a previous decision of another Judge of the Supreme Court (unreported), has held, in effect, that they are an accretion to capital, but that the persons entitled to the income of the estate are entitled to a charge upon them for a sum which, although in form a dividend upon existing shares, was never actually paid as such but was accepted by the Company in full payment for the shares, which were of much greater value.

The transactions in question are of a kind not unfamiliar. The Company, having accumulated large funds of surplus profits after payment of ordinary dividends, proposed to distribute those funds amongst their shareholders, the operation taking in

(1) 12 App. Cas., 385, at p. 405.
(2) (1907) 1 Ch., 289.
(3) (1893) 3 Ch., 337.
(4) (1905) V.L.R., 599, at p. 604; 27 A.L.T., 19.

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each case the form of an issue of new shares accompanied by a distribution by way of bonus of an amount exactly equal to the amount payable in respect of the new shares. The question is whether the amount of the bonus is to be regarded as income or as an accretion to capital.

The principle to be applied in answering that question is declared by the case of *Bouch* v. *Sproule* (1), by which we are bound. The principle is that regard is to be had to the intention of the Company as evidenced by the substance and not the form of the transaction. If the substance of the transaction is that the Company determine to convert the undivided profits into paid up capital upon newly created shares, then those shares are capital. If, on the other hand, the substance of the transaction is that the Company determine to make a distribution of profits, accompanied by an option to the shareholders either to accept their proportion of the fund in cash or to apply it in the purchase of new shares in the Company, the amount so distributed may be regarded as income, whether it is actually paid and repaid or not. In *In re Evans* (2) *Neville* J. thus expressed the principle:—"What was the nature of the scheme? Was the scheme intended by the Company to result in the transfer of the amount or part of the amount standing to the credit of the reserve fund to the payment of new capital to be distributed amongst shareholders, or was it merely an ordinary distribution of dividends out of the reserve fund, leaving it a matter of pure choice, with regard to which the Company expressed no desire at all, as to how it should be applied?"

In the present case the schemes (for there were two separate transactions) were in each case expressed in the form of four resolutions. By the first the capital of the Company was increased by £100,000, in 100,000 new shares of £1 each. By the second it was resolved that the new shares should be offered to the shareholders at par in the proportion of one new share for every nine shares (in the second case every ten shares) held by them, on the footing that the full amount should be paid on acceptance of the offer within a time to be limited by the directors for acceptance. By the third resolution it was resolved that the

(1) 12 App. Cas., 385.

(2) (1913) 1 Ch., 23, at p. 32.

sum of £100,000, being portion of the amount standing to the credit of the Company's reserves, should be distributed amongst the shareholders by way of bonus in proportion to the number of their shares, and that each shareholder might direct in writing that the amount of bonus should be used in payment for the new shares. By the fourth resolution the directors were authorized to dispose of new shares so offered and not accepted to such persons and upon such terms as they might think most advantageous, and that the premiums received for the sale of such shares should be divided *pro ratâ* amongst the shareholders who did not accept the new shares.

It appears, therefore, that the only substantial option left to the shareholders was, in each case, not how their proportion of an ordinary distribution of funds by way of dividend should be applied, but whether their proportion of new capital, which was to be created at all events, irrespective of any option on their part, in the form of fully paid up shares, should be taken by them in the form of shares or in the form of money representing their proportion of the proceeds realized by a sale of the new shares not taken by shareholders *in specie*. It is common ground that the value of the new shares would exceed the nominal amount of the bonus or dividend.

Under these circumstances it appears to me that the substance of each transaction was not a distribution of a dividend or bonus, but a creation of additional capital, or, in the words of Lord *Herschell* (1), "to convert the undivided profits into paid-up capital upon newly-created shares." The real and substantial option was, as I have said, not to take or refuse to take a dividend *quâ* dividend, but to take new shares *in specie* or to take a sum substantially representing their value.

In whichever way it was exercised, the shareholder was to get substantially the same benefit, the only difference being that in one case the new shares would be disposed of for his benefit, and in the other taken by himself *in specie*.

If the contrary view is accepted I have some difficulty in seeing any ground for dividing the benefit between the tenant for life and remaindermen. The benefit, whatever it was, was

(1) 12 App. Cas., 385, at p. 399.

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either a payment of income or a creation of capital by way of accretion, and must, I think, belong to one or the other. It is true that in *In re Northage* (1) *North* J. saw his way to divide it, but the facts of that case were very different from the present.

I will only add that I am much impressed by what I venture respectfully to call the strong common sense of Lord *Eldon's* remark in *Irving* v. *Houston* (2) that "If . . . . a person who buys bank stock . . . . gives the life interest of his estate to anyone it can scarcely be his meaning that the life-renter should run away with a bonus that may have been accumulating as capital for half a century."

The question is, after all, one of construction of the will. In my judgment the benefit which accrued to the trustees under the schemes in question was not income in the sense in which that term was used by the testator.

In my opinion the appeal should be allowed, and the order should be varied by omitting the declarations that the tenants for life are entitled to a charge on the shares and that the amount of the charge should be raised by a sale of a sufficient number of them.

The judgment of ISAACS and GAVAN DUFFY JJ. was read by

ISAACS J. The point decided in *Bouch* v. *Sproule* (3) is thus stated in *Lindley on Companies*, 6th ed., p. 742:—"If a company can lawfully increase its capital, and it does so by capitalizing and distributing its accumulated profits, then what is distributed in respect of shares held for life must be treated as capital, whether what is distributed is cash or new shares."

But it is essential that the distribution of the profits must be so as to increase the capital, and that by force of the act of the company itself, leaving no room for discretion in the matter by the recipient of the profits as to their ultimate destination.

It is clear that the process of converting profits into capital in the necessary sense, cannot be effected without distribution as a step in the process, because, as was pointed out by Lord *Herschell* in *Bouch* v. *Sproule* (4), the company "cannot be considered as

(1) 64 L.T., 625.
(2) 4 Paton, Sc. App., 521.
(3) 12 App. Cas., 385.
(4) 12 App. Cas., 385, at p. 398.

having intended to convert, or having converted, any part of its profits into capital when it has made no such increase," that is, increase of capital stock. The profits to become capital must be paid for capital stock. And, before being so paid, they must in law be the property of the applicant for that stock. The next postulate is that when profits are distributed they belong absolutely to the recipient, and cannot be clogged with a condition binding in law to return them or apply them to the payment of shares. In the strict legal sense there is always an option to retain the profits and refuse to take the shares which the company desires to be taken and paid for by means of the profits. But the question is one of business and hard fact, and it is the substance of the transaction which governs the relations of tenant for life and remainderman.

The company may so frame its resolve to issue new shares, and to distribute the profits, as to bind the two into one transaction from a practical standpoint. But, to accomplish this, the bonus or dividend must be so offered that the ordinary instincts of human self-interest of a reasonably prudent man will naturally and instantly direct the money back into the coffers of the company in exchange for the new shares contemporaneously offered, notwithstanding that these are legally refusable by the shareholder. If the distribution is made in such terms, and in such surrounding circumstances, that the ordinary promptings of human nature would lead to the one act accompanying the other, they may be regarded as indispensable and inseparable parts of one transaction, and the benefit offered by the company is simply the net difference between the actual value of the shares and the price asked, including in that the money distributed for the purpose of paying the price in whole or in part.

If that is the position, the tenant for life cannot assert that the dividend has been received by the trustees for him. In truth it has not. It has not been received by the trustees at all for incorporation in the estate, but they are mere conduit-pipes to receive and pass it on for a given purpose.

When these considerations are applied to the present case, it is obvious that the Company have stopped short of irrevocably linking the distribution of profits with their return. They have

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not supplied the want of a legal compulsion with a practical one. They have afforded a ready and facile means of paying for the shares, and have thereby made the acceptance of the new shares more probable. But they have not put any pressure whatever upon the shareholders to take the new shares. On the contrary, they have said in effect: "Notwithstanding the facilities we afford you to take the new issue, if you do not choose to take them you shall not be penalized. You shall still have, besides the share of profits, your share of whatever premiums we obtain from outside contributions."

That stops short of the practical compulsion necessary to weld the two branches of the transaction together; it leaves a full and free option from a business standpoint; and as neither law nor self-interest can be said to compel the repayment of the profits distributed, they have not been capitalized and remain income.

In view of the facts, we think the decretal order of *Harvey* J. should stand as made, including the declarations respecting the charge upon the shares for the amount of the bonuses.

Appeal dismissed. Costs of all parties as between solicitor and client to be paid out of the fund.

Solicitors, for the appellant, *Macnamara & Smith.*

Solicitors, for the respondents, *Stephen, Jaques & Stephen*; *Macnamara & Smith.*

B. L.