RESCISSION OF CONTRACTS TO TAKE COMPANY SHARES

By P. F. P. HIGGINS*

The whole question of the rescission of contracts on the ground that one party had been induced to contract by a representation made innocently by the other was examined and reported upon by the Law Reform Committee in July 1962.[1] The Committee's report and recommendations touch upon certain aspects of rescission that, hitherto, do not appear to have been fully appreciated either by the judiciary or by the text-writers.

Much of the uncertainty on the question of rescission of contracts arises from the proposition that a contract cannot be rescinded on the ground of innocent misrepresentation once it is executed, unless that misrepresentation also gave rise to a fundamental mistake common to the parties.[2] With regard to contracts to take shares in a company this proposition is sometimes stated to have been laid down as a rule of law in *Seddon* v. *North Eastern Salt Company*.[3] Neither the proponents nor the critics of the so-called rule appear to have considered in any detail what is meant by 'executed' in this context and, furthermore, they have failed to appreciate that, whilst the substantive conditions precedent for the formation of most contracts are identical, the legal relationships arising from contracts are infinite in variety.[4]

The object of this paper is to examine the present position as to the availability of rescission for innocent misrepresentation in the particular context of contracts for the sale of company shares and then to consider the possible effects of the recommendations of the Law Reform Committee.

There are two basic methods by which a person may seek to acquire shares in a company. In the first place, he may contract directly with the company by applying to its promoters or directors for the allotment of shares to him either on the formation of the company or on the occasion of a new issue of shares. Secondly, he may negotiate with an existing shareholder for the transfer of his shares. The first of these methods entails a bipartite contract between the intending shareholder and the company; the promoters or directors, as the case may be, are merely

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1 Law Reform Committee—Tenth Report (Innocent Misrepresentation)—Cmnd. 1782.

2 *Kennedy* v. *Panama Mail Co.* (1867) L.R. 2 Q.B. 580.

3 [1905] 1 Ch. 326.

4 The Committee has given partial recognition to this aspect of contracts in making special recommendations with regard to contracts concerning land.

the agents of the company and as such are not normally parties to the contract. The second method involves a tripartite transaction between the transferor, the transferee and the company and it is in some ways similar to an agreement for the transfer of a chose in action.

It was with the second method of acquisition that *Seddon's Case* was concerned and, indeed, it has been stated that the rule in that case has no application to contracts to acquire shares directly from the company.[5] For this reason alone it is essential, when considering the availability of rescission for innocent misrepresentation, to examine each of the two kinds of transactions in isolation. Before carrying out that examination, it may be of some assistance to review the nature of the subject matter of both transactions, namely, the rights to be acquired by the shareholder vis-a-vis the company and the other shareholders in it.

Nature of the Shareholder's Interest

The rights and obligations of shareholders are governed by the memorandum and articles of association of the company. These documents not only constitute a binding contract between each member and the company but also regulate the rights and obligations of the shareholders *inter se*.[6] However, as a general rule, it is for the company to enforce the contract against a member, and only in exceptional circumstances can it be enforced by the individual members.[7] Although it has been stated that the articles of association constitute a binding contract between the individual members of a company, it is submitted that the true position is as was stated by Lord Herschell, in *Welton* v. *Saffery*:[8]

> It is quite true that the articles constitute a contract between each member and the company, and that there is no contract in terms between the individual members of the company; but the articles do none the less, in my opinion, regulate their rights *inter se*. Such rights can only be enforced by or against a member through the company, or through the liquidator representing the company; but I think no member has, as between himself and any other member, any right beyond that which the contract with the company gives.

An examination of the memorandum and articles of almost any company will reveal that they constitute a contract of continuing obligations[9] on the part of the company, at least, and that those obligations will subsist as long as the company is in being. Therefore it may be said

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5 See the observations in *Buckley, infra,* n. 12 and of McCardie J. in *First National Reinsurance Co.* v. *Greenfield, infra,* n. 16.

6 Companies Act 1962, s. 33.

7 Rule in *Foss* v. *Harbottle* (1843) 2 Hare 461. As to the exceptions to the rule see Gower's *Modern Company Law,* 2nd ed., at 528-531.

8 [1897] A.C. 299, 315. However, in view of the decision in *Clarke* v. *Dunraven (Earl)* [1897] A.C. 59, it might well be argued that there is an implied contract between the shareholders but that it is a term of that contract that it will only be enforced through the company.

9 The existence of this type of contract is recognised by the Committee in para. 10 of the Report: 'Even at the present time there are many contracts of a continuing nature, like partnership, agency or service agreements, which in a sense always remain executory and therefore open to rescission.'

that the contract between the company and its members remains executory throughout. Indeed this executory aspect of the contract receives strong support from the view that the courts have taken of the nature of the shareholder's interest in the corporate property. In *Macaura* v. *Northern Assurance Company*,[10] Lord Buckmaster said:

> Now, no shareholder has any right to any item of property owned by the company, for he has no legal or equitable interest therein. He is entitled to a share in the profits while the company continues to carry on business and a share in the distribution of the surplus assets when the company is wound up and all its creditors are paid in full.

These rights of the shareholder have sometimes been described, on the analogy of a partner's interest in the partnership property, as a lien. That term might not be strictly accurate but it does serve to emphasise that the shareholder's rights do not attach to any specific property until the affairs of the company are wound up and its creditors have been paid in full. It follows then that the shareholder's rights are executory until such time as the contract between himself and the company is terminated.

It is, however, of the utmost importance to distinguish the contract embodying the rights of a member of a company from the preliminary contract which entitles him to be admitted to membership. This preliminary contract will usually be executed, in the sense that each party has performed his fundamental obligations, when the shareholder has paid what is required for his shares and his name has been entered on the register of members. Clearly neither of these two contracts can be rescinded unless the other is also rescinded, but it is submitted that, in determining whether or not the equitable remedy of rescission is available, a considerable amount of confusion will be avoided, if it is appreciated that in reality two contracts are involved: one, the contract to take shares, which may be executed, and the other the contract of shareholding, which remains executory throughout.

Acquisition of Shares from the Company

Under this heading there are two methods by which a person may become a member of a company limited by shares. In the first place he may be a subscriber to the company's memorandum, thereby undertaking to take a number of its shares when it is incorporated. In such a case the subscriber automatically becomes a member as soon as the company is registered and the subsequent entry of his name on the register of members is a formality which has no legal effect on his relationship with the company.

Secondly, the intending member may enter into an agreement with the company whereby he agrees to take a certain number of its shares. In this case he does not become a member of the company until his name is entered on the register of members. The normal procedure is that the

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10 [1925] A.C. 619, 626-627.

company issues a prospectus inviting members of the public to subscribe to its share capital. The prospectus and the form of application for shares which usually accompanies it do not constitute an offer but merely an invitation to make an offer on the basis that, if his offer is accepted by the company, the offeror will take up and pay for the number of shares he has applied for, or such lesser number as are allotted to him. The offer is accepted when the company sends a letter of allotment to the offeror notifying him of the number of shares which have been allotted to him.[11] At this stage the company and the offeror are contractually bound and, although he does not become a member of the company until his name is entered on the register of members, the intending shareholder has contractual rights which are capable of being, and often are, the subject matter of an assignment.

In the second case, which is the more usual kind of transaction, it is clear, on any view, that until the shareholder pays for his shares and his name is entered on the register the contract between him and the company remains executory. Therefore that contract may be rescinded according to normal equitable principles on the ground that it was induced by an innocent misrepresentation. On the other hand, once his name has been entered on the register and he has paid for his shares, the contract to take shares, as distinct from the contract of shareholding, has become executed.

The question then arises as to whether, apart from statute, a contract to take shares can be rescinded after it is executed by the entry of the representee's name on the register of members on the ground that it was induced by an innocent misrepresentation. Although it has been stated that in such circumstances rescission is still available, because the rule in *Seddon's Case* has no application where the shares are acquired directly from the company, there appears to be no decided case that gives unqualified support to that proposition.

In *Buckley on the Companies Act*,[12] it is stated that an innocent misrepresentation is not [a] ground for setting aside an executed contract for sale. *Semble*, however, the relation constituted between company and allottee is not one of sale but of contract, which remains in contract after registration of the allottee's name and can be set aside on the ground of innocent misrepresentation. With respect, the three cases cited in support of this statement of the law lend it little if any support, but out of respect for such high authority it is necessary to let the cases speak for themselves.

In *Reese River Silver Mining Co.* v. *Smith*,[13] Lord Hatherley said: 'Because it was the duty of the directors not to wait for the filing of the bill, if they knew, as we must assume them to have known, that the

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11 For a detailed account see Gower, *op. cit.*, at 348 *et seq.*

12 13th ed., at 269.

13 *Buckley* cites the decision of the Lords Justices, (1867) 2 Ch. App. 604. The above quotations are from the House of Lords Judgments affirming their decision, (1869) L.R. 4 H.L. 64, 74. Italics supplied.

contract had been entered into upon those *fraudulent* representations.' Lord Westbury said:

> I apprehend, therefore, that your Lordships' order in this particular case will only enunciate this proposition, that if, on the ground of *fraud* well founded, the Plaintiff files his bill anterior to the winding-up order to have his name removed from the register . . . he has a right to pursue that suit to its consequence. . . .[14]

Lord Cairns said: '. . . and I hardly think that it was gravely argued at the Bar in this case a *fraud* had not been committed against the Respondent'.[15] Clearly this case is no authority as to rescission on the ground of *innocent* misrepresentation.

In *First National Reinsurance Co.* v. *Greenfield*,[16] Lush J. said:

> The action was one for calls. The defendant resisted it on the ground that, as he alleged, there had been a *fraudulent* misrepresentation in the prospectus. Mr. Ralston for the defendant has told us that fraud was not specifically alleged, but he says there was a misrepresentation which amounted to fraud. Nothing turns upon the distinction and I will treat the defence as alleging *fraudulent* misrepresentation.

On the other hand, McCardie J. said:[17]

> The effect, however, of the company decisions is to show that contracts for the taking of shares, even though followed by allotment and the placing of the applicant upon the register, are not contracts which fall within the principle of *Seddon's Case*. It might well have been thought that they fall within that principle, but in fact they do not, as is established with reasonable clearness in *Smith's Case*: *Reese River Silver Mining Co.* v. *Smith*; . . .

Now, we have already observed that *Smith's Case* was one of fraudulent misrepresentation and therefore, in so far as McCardie's statement is not *obiter* it must be taken as having been made *per incuriam*.

The third case, *Re Pacaya Rubber & Produce Co.*,[18] appears to have been a case of repudiation for breach of condition and not one of rescission for innocent misrepresentation. It is submitted that this is made quite clear in the first paragraph in the headnote: 'Where a company issues a prospectus inviting application for shares on the faith of *bona fide* statements of fact expressly based on the *bona fide* report of an expert, the accuracy of those statements is *prima facie* the basis of the contract.' Indeed, Professor Gower suggests that material statements in a prospectus are conditions of the contract and that if they are untrue they may provide a ground for avoiding the contract.[19] However,

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14 *Ibid.* at 77. Italics supplied.
15 *Ibid.* at 79. Italics supplied.
16 [1921] 2 K.B. 260, 263. Italics supplied.
17 *Ibid.* at 272.
18 [1914] 1 Ch. 542.
19 *Op. cit.* at 299, n. 52, and see the observations of Lindley L.J. in *Karberg's Case* [1892] 3 Ch. 1, 11: 'Applying this principle to the present case, it follows that the misrepresentation proved to have been made in the prospectus, although not made by the company or its agents, vitiated the only contract into which Karberg and the company entered, and entitled Karberg to repudiate it, provided it was material to the contract and the repudiation was made in time.' It is clear that Lord Lindley was referring to the common law *right* to repudiate for breach of condition and not to the discretionary equitable remedy of rescission for innocent misrepresentation and his words were quoted with approval by Astbury J. in the *Pacaya Case*.

avoidance or repudiation of a contract on this ground is a common law right quite distinct from the equitable remedy for innocent misrepresentation which is purely discretionary.

Once it has been established that there was a material misrepresentation of fact in the prospectus, then, subject to the fact that the remedy must be sought within the proper time, the contract may be avoided and the register of members may be rectified in accordance with section 155 of the Companies Act 1962.[20] That section also provides for the payment of damages where the register is rectified, so that in this context it is immaterial whether the statement was made innocently or fraudulently. In fact, because of the statutory provision, the otherwise arguable proposition that the preliminary contract to take shares merges in the resultant contract of shareholding, so that the prospectus is overridden by the memorandum and articles of association, is of no material importance.

The above considerations will apply almost invariably in the case of a public company where shares are acquired directly from that company whether by subscription to the memorandum or by application and allotment because, generally speaking, any misrepresentation inducing the contract will be contained in the prospectus. In this connection, it must be borne in mind that certain advertisements inviting subscriptions and documents containing offers of shares for sale are, under the provisions of the Companies Act 1962,[21] deemed to be prospectuses.

On the other hand, a proprietary company is a company which, *inter alia*, prohibits any invitation to the public to subscribe for its shares. Therefore, negotiations leading to membership of a proprietary company may often be informal and, in consequence, there will frequently be considerable difficulty in determining whether statements made during those negotiations were merely representations or were, in fact, terms of the contract to take shares.

Unfortunately, the whole history of the growth and development of proprietary or private companies has been a subject of anomaly and paradox and the proprietary company may well be regarded as the *Ornithorynus Paradoxus* of corporation law. In fact it is a partnership. In law it is a corporation and, as a result of *Salomon's Case*,[22] a legal entity distinct from its constituent members. As Professor Gower has pointed out, Lord Lindley never appeared to have relinquished the view that company law is merely an extension of the law of partnership. There is much to be said for that view, in that it reduces a somewhat metaphysical conception of the body corporate to a practical business concept that may be understanded of the people. In practice the Courts are only too frequently driven into explanations of the limited liability company in the

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20 All references to the Companies Act are to the uniform legislation in the States of the Commonwealth which resulted in the Companies Act 1962, in Tasmania.

21 Ss. 40 and 43.

22 *Salomon* v. *Salomon Ltd.* [1897] A.C. 22, 33-34.

terms of partnership, and in spite of his castigation of the Court of Appeal in *Salomon's Case* for having failed to appreciate the real existence of the corporation as a distinct legal entity, Lord Halsbury himself, in the *Daimler Case*,[23] was content to analyse certain aspects of a limited liability company in the terms of partnership. What does emerge is that, in spite of the highly technical concepts of incorporation, perpetrated by the Judiciary and perpetuated by the jurisprudentialists, the private or proprietary company has a strong affinity with the unincorporated partnership.

In the case of partnerships it is statutorily provided that misrepresentation as well as fraud will afford a ground for the rescission of the contract of partnership.[24] *Adam* v. *Newbigging*[25] is the highest authority for the proposition that in this connection the Partnership Acts are merely declaratory of the pre-existing law. Moreover, in the case of partnership there is the same duality of contract as there is in the case of the acquisition of shares in an incorporated company. That is to say, there is a preliminary contract to admit a person into partnership which results in the continuing contract of partnership.

It will be appreciated that this duality is no mere rationalisation when it is realised that the preliminary contract to admit a person into partnership may be the object of an order for specific performance[26] whereas the continuing contract of partnership, being a contract involving personal service, cannot be specifically enforced. Furthermore, the continuing contract of partnership is one of the contracts *uberrimae fidei*, whilst the contract for admission into partnership is not.[27]

In spite of the decision in *Salomon's Case*, the courts in dealing with some of the aspects of company law have not hesitated to act upon the analogy of the law of partnership. It is submitted that the well-established principle that a partnership may be rescinded on the ground that it was induced by an innocent misrepresentation affords a *prima facie* case for the rescission of a contract to take shares in a private or proprietary incorporated company.

There is, however, at least one apparently substantial objection to the application of this partnership principle to corporate bodies. In the case of a partnership, when the contract is rescinded, the representee partner is merely relieved of his liability to his co-partners, because on the

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23 *Daimler Tyre Co.* v. *Continental Tyre and Rubber Co. (Great Britain) Ltd.* [1916] 2 A.C. 307, 316: 'Under these circumstances it becomes material to consider what is this thing which is described as a "corporation". It is, in fact, a partnership in all that constitutes a partnership except the names, and in some respects the position of those who I shall call the managing partners.'

24 Partnership Act 1891, s. 46; Partnership Act 1890 (Eng.), s. 41.

25 (1888) 13 App. Cas. 308.

26 *Renowden* v. *Hurley*, [1951] V.L.R. 13.

27 In *Lindley on Partnership*, 12th ed., at 342, it is stated that the requirement of the utmost good faith extends to persons negotiating for a partnership. The only partnership case cited in support of this proposition does not bear it out. In *Fawcett* v. *Whitehouse*, (1829) 1 R. & M. 132, one of the intending partners was constituted the agent of the others for the purpose of acquiring certain properties. It is clear that this fiduciary duty arose out of the preliminary agency and not out of the intended partnership.

ordinary principles of 'holding out' he will remain liable to third parties who have dealt with the partnership firm on the basis that he was apparently a partner. It is true that the Act entitles him to be indemnified against such liabilities by his co-partners,[28] but the fact remains that he is still primarily liable to the third parties and, if his co-partners are insolvent and unable to contribute, he will, in effect, be solely liable.

In such circumstances complete rescission, purely on the score of practicability, would be out of the question in the case of a public company with a large number of shareholders. There the misrepresentation will usually have been made by the promoters or directors so that the complications involved in adjusting the rights *inter se* of a large number of shareholders, some of whom have been misled and some of whom have not, would be almost insoluble. However, in the case of a proprietary company, where as in a partnership there is a statutory limit on the number of members, there appears to be no valid reason against rescinding the agreements between the members and the company and the members, *inter se*, provided each member remains under his limited liability to the outside creditors of the company.

Acquisition of Shares from Existing Shareholders

Whether the intending shareholder purchases his shares directly from an existing shareholder or whether he acquires them through the intermediation of a stockbroker, as is usually the case where the shares are those of a public company, the basic nature of the transaction is the same. In effect, the transferor contracts to vest his rights against the company in the transferee and the transferee contracts to undertake the transferor's obligations to the company. Although the headnote to *Seddon's Case* describes the transaction as the sale of a chose in action, it is probably something more than that, because it is possible that the transferee acquires certain proprietary rights vis-a-vis the company which are not merely contractual rights *in personam*.[29] However, whatever may be the true nature of the transaction, it certainly is not a sale of goods, so that the provisions of the Sale of Goods Act 1896[30] which exclude the right to repudiate the contract for breach of condition, and *a fortiori* to rescind on the ground of innocent misrepresentation, after the property in specific goods has passed to the buyer have no application to a contract for the sale of a company's shares.

Again the duality of the transaction under which the company originally allotted its shares must be borne in mind. We have already observed that material statements in the prospectus are conditions of the contract to take shares from the company and that if such statements are false that contract, and with it the contract of shareholding, may be repudiated. Now, if these two contracts were in fact one inseparable contract and the transfer by the original shareholder was an assignment

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28 S. 46, n. 24, *supra*. This statutory indemnity resolves the question that was left open by the House of Lords in *Adam* v. *Newbigging*, *supra*, n. 25.

29 See Gower, *op. cit.*, at 319-323.

30 S. 16 (3): Sale of Goods Act 1893 (Eng.), s. 11 (1) (c).

of a chose in action, it is possible that any right he might have to repudiate would pass to his assignee. However, in *Peek* v. *Gurney*,[31] the House of Lords held that a misrepresentation in the prospectus does not enable a person who did not acquire his shares directly from the company to rescind the contract of shareholding. It appears, then, to be reasonably clear that when an existing shareholder transfers his shares he merely assigns his contract of shareholding and not the rights under his contract to take shares.

Seddon's Case was, in fact, an action for the rescission of a contract for the purchase of shares from an existing shareholder after the transaction had been completed by the registration of the shares in the buyer's name. The buyer based his claim to rescind on the ground of innocent misrepresentation but, in dismissing the claim, Joyce J. held as a fact that there had been no misrepresentation at all.[32] It is arguable, therefore, that the statement in the headnote that rescission will not be granted of an executed contract for the sale of a chattel or a chose in action on the ground of innocent misrepresentation represents the judge's *obiter dictum* and not the *ratio decidendi* of the case. Be that as it may, the fact remains that there has been no case, either before or since *Seddon's Case*, deciding that a contract for the transfer of company shares on sale can be rescinded after the transaction has been completed by the entry of the transferee's name on the company's register of members.

What is even more significant is that, in spite of the enormous increase in the number of incorporated trading companies and in the volume of dealings with company shares since *Seddon's Case* was decided, there has been no reported decision of a case in which a transferee has claimed rescission on the ground that he was induced to take the shares by an innocent misrepresentation. This affords a strong indication that in spite of the criticisms of *Seddon's Case*, by members of the judiciary and by textwriters, business men and their legal advisers have been prepared to accept the statement of the law as set out in the headnote to that case.

It must be remembered that rescission for innocent misrepresentation is an equitable remedy and that, although there may be differences of opinion as to the precise degree of fusion effected by the Judicature Act 1873 (Eng.), it has never been seriously contended that equitable remedies have ceased to be discretionary. Furthermore, since the time of Lord Eldon, if not before, the exercise of discretions in equity has been a matter of precedent rather than conscience.[33] With regard to

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31 (1873) L.R. 6 H.L. 377.

32 [1905] 1 Ch. 326, 335.

33 'Nothing would inflict upon me greater pain, in quitting this place, than the recollection that I had done anything to justify the reproach that the equity of this Court varies like the Chancellor's foot.' *Per* Lord Eldon in *Gee* v. *Pritchard* (1818) 2 Swanst. 402, 414. Lord Eldon was of course referring to Selden's criticism: 'Tis all one if they should make ye Standard for ye measure wee call a foot, to be ye Chancellor's foot. . . .' (*Table Talk of John Selden*, ed. Pollock, 1927, at 43). *Cf.* the observations of Lord Nottingham in *Cook* v. *Fountain* (1676) 3 Swanst. 585, 600.

rescission of contracts equity has always taken the view that the remedy is no longer available after third parties have acquired rights under the contract. Now, in the case of a transfer of shares the company acquires rights against the transferee and the transferee acquires obligations to the company as soon as the company has entered his name on its register of members. For this reason alone, it is submitted that rescission of the transfer cannot be granted in accordance with the existing law.

The view of *Seddon's Case* taken by the Law Reform Committee is, with respect, the only practical one and, indeed, when it is remembered that the decision in that case has not been challenged in the courts for a period of nearly sixty years, the only just one. Of it the Committee said:

> However, whatever its merits in law, the rule in *Seddon's Case* is today generally accepted and acted upon. Even if, as we think, it is not impossible that the rule may yet be held by the Court of Appeal or the House of Lords to be without foundation, it cannot be right to leave a matter of such everyday importance to be settled by the accidents of litigation. In our view, it should be provided by statute that (except in the case of those contracts for the sale or other disposition of an interest in land to which we have already referred) the fact that a contract has already been executed should not of itself be a bar to proceedings for rescission.[34]

The Recommendations of the Law Reform Committee

The Committee has made eight recommendations. Of these, (1) dealing with contracts relating to interests in land, (4) dealing with sales of goods, (6) dealing with hire-purchase contracts and (8) suggesting possible amendments to the Sale of Goods Act 1893 (Eng.) are unlikely to affect transactions in company shares. Recommendation (5) substantially extends the provisions of the Directors Liability Act 1890 (Eng.), which are now contained in section 46 of the Companies Act 1962, to all contracts and in effect appears to substitute a principle of *caveat venditor* for the traditional *caveat emptor*.[35] Recommendation (7) reinforces (5) by nullifying the effect of exclusion clauses, unless the representor can prove that up to the time that the contract was made he had reasonable grounds for believing the representation to be true. The general effect of the recommendations tends to make every representation a legally binding stipulation without clothing it in the decent formalities of the *stipulatio*.

Recommendations (2) and (3) apply to contracts generally and, although in making them the Committee does not appear to have considered the inherent peculiarities of dealings with company shares, they

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34 Tenth Report, at 6, para. 9.

35 This possibility was forecast by Mann A.C.J. in *Watt* v. *Westhoven,* [1933] V.L.R. 458, 463: 'I should add with regard to Mr. Barry's argument, that if it were thought desirable to restrain the enthusiasm of salesmen with a new motto, *caveat vendor* (*sic*), it would in my opinion require more than an amendment of sec. 4 of the Goods Act to effect the change. Much of the language, and the arrangement in which the Act has codified the common law, would have to be revised to accommodate a doctrine whereby every warranty would become a condition, and every inducing statement not warranted would be a condition also.' See also the observations of L. S. Sealy in (1963) *Cambridge Law Journal,* at 7 *et seq.*

are presumably intended to apply to such dealings and therefore call for an examination in that context.

(2) *All other contracts should be capable of being rescinded after execution but the other bars to rescission should remain as at present.*

In paragraph 10 of the report the Committee mentions the existing bars to rescission.

> Delay in seeking rescission (either by itself or because it raises an implication that the contract has been affirmed) will continue to operate as a bar, and so will any change of circumstances making *restitutio in integrum* impossible, such as the intervention of the rights of third parties. In addition, the normal periods of limitation will apply.

'Delay in seeking rescission by itself' must be taken as referring to the equitable doctrine of laches and that, together with the normal periods of limitation, being of general application, does not call for any special comment in connection with share transactions.

As to delay raising an implication that the contract has been affirmed, it was held in *Leaf* v. *International Galleries*,[36] that whereas the equitable doctrines of laches does not come into operation until the representee has become, or ought to have become, aware of the falsity of the representation and even though *restitutio in integrum* is still possible, mere delay, falling short of the statutory period of limitation, can amount to an affirmation of the contract so as to bar the equitable remedy of rescission.

With regard to the impossibility of *restitutio in integrum*, the problem as to where restitution ends and damages begin was formerly one of great complexity but, as Professor Gower has pointed out,[37] since the decision of the House of Lords in *Spence* v. *Crawford*,[38] the requirement of *restitutio in integrum* appears to mean little more than that the court must be able to effect substantial justice between the parties.

Nevertheless, in the context of share transactions the intervention of the rights of third parties raises peculiar problems in connection with rescission and, in view of what has been written on the subject, it is surprising that neither this Committee nor the Jenkins Committee on Company Law Reform[39] has considered the matter.

If the contract of shareholding is basically a bipartite contract between the company and the shareholder, it might be said that it gives rise to the vesting of third party rights in two independent groups, namely, the other shareholders and the company's creditors. Therefore,

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36 [1950] 2 K.B. 86 (C.A.) Sealy, *op. cit.*, at 9, states, 'One further consequence (with few to regret the passing) will be that *Leaf* v. *International Galleries* [1950] 2 K.B. 86, will disappear from the textbooks.' With respect, this may be true with regard to the judgment of Denning L.J. but it is submitted that recommendation (2) must be read in the context of paragraph 10 of the Report. That paragraph clearly preserves the distinction between laches and affirmation by delay upon which Jenkins L.J. expressly based his judgment in *Leaf's Case* (at 362).

37 (1950) 13 M.L.R. at 362.

38 [1939] 3 All E.R. 271.

39 Report of the Company Law Committee—June 1962—Cmnd. 1749.

if such rights are to be a bar to rescission, it becomes important to determine at what precise point they become vested.

As we have already observed, the rights and obligations of shareholders, *inter se*, are governed by the company's memorandum and articles of association and during the subsistence of the company the right to enforce them is vested in the company and not in each individual shareholder. It appears, then, that, at any rate until the company is wound up, these rights are not strictly third party rights. Although the company is a legal entity distinct from its constituent members, the enforcement of the *inter se* rights of the shareholders arising out of the contract of shareholding have been relinquished to the company under the contract with the company. On the other hand, when the company is being wound up, it is the duty of the liquidator, amongst other things, to adjust the rights of the shareholders *inter se*, so that it is at that stage that the individual shareholder's rights can be said to have crystallised into true third party rights, the existence of which is a bar to rescission.

In much the same way, because, as a general rule, company shares are freely transferable during the continuance of the company's business, the rights of the creditors are against the company and not against any individual shareholder until such time as the company goes into liquidation. This aspect of the trading corporation, which emphasises its difference from the unincorporated partnership was clearly explained by Lord Cairns in *Tennent* v. *City of Glasgow Bank*.[40] His Lordship said:

> In an ordinary partnership, not formed on the joint stock principle, it is impossible, as a general rule, for a partner at any time to retire from or repudiate the partnership without satisfying, or remaining bound to satisfy, the liabilities of the partnership. He may have been induced by his co-partners by fraud to enter into the partnership, and that may be a ground for relief against them, but it is no ground for getting rid of a liability to creditors. This is the case whether the partnership is a going concern, or whether it has stopped payment or become insolvent. In the case of a joint stock company, however, the shares are in their nature transferable, and transferable without the consent of creditors, and a shareholder, so long as the company is a going concern, can by transferring his shares, get rid of his liability to creditors, either immediately or after a certain interval. The assumption is that, while the company is a going concern, no creditor has any specific right to retain the individual liability of any particular shareholder.

However, his Lordship went on to explain that once the company goes into liquidation the liability of the individual shareholder to the creditors is crystallised and it is no longer open to him to avoid the contract of shareholding, even where the contract was induced by fraud:

> But if the company has become insolvent, and has stopped payment, then, even irrespective of winding-up, a wholly different state of things appears to me to arise. The assumption of new liabilities under such circumstances is an affair not of the company but of its creditors. The repudiation of shares which, while the company was solvent, would not or need not have inflicted any injury upon creditors must now of necessity inflict a serious injury on creditors. I should, therefore, be disposed in any case to hesitate before admitting that, after a company has become insolvent and stopped payment, whether a winding-up has commenced or not, a rescission of a contract to take shares could be permitted as against creditors.[41]

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40 (1879) 4 App Cas. 615, 621.
41 *Ibid.* at 622.

Although Lord Cairns expressly confined his judgment to the particular facts of the case before him, the principle which he laid down has been applied on many occasions and it can be said with some certainty that the remedy of rescission for misrepresentation is not available after the commencement of winding up.

(3) *Where the Court has power to order rescission (whether before or after the execution of the contract) it should have a discretion to award damages instead of rescission if it is satisfied that damages would adequately compensate the plaintiff having regard to the nature of the representation and the fact that the injury is small compared with what rescission would involve.*

It is unfortunate that in making this recommendation the Committee did not have its attention specifically directed to the present somewhat anomalous position with regard to company shares. In *Houldsworth* v. *City of Glasgow Bank*,[42] it was held that damages for fraudulent misrepresentation against the company cannot be awarded unless the claimant repudiates his contract of shareholding. Although in that case the claimant was unable to repudiate because the company was being wound up, the general tenor of the judgments suggest that even if the company had been a going concern the claimant could not have affirmed the contract of shareholding and recovered damages. Clearly, in so far as the *Houldsworth Case* decides that damages can never be recovered unless the contract is rescinded, it will be nullified if the Committee's recommendation is put into effect. It is important then to ascertain whether that decision was based upon any fundamental principle of company law.

The basis of the rule in *Houldsworth's Case* has been the subject of some disagreement between Professor Gower and Professor Hornby.[43] Professor Gower has said:

> In laying down this rule the House do not seem to have realised fully the separation between the corporate entity and the member, but the decision can be explained on two grounds. The first is that to recover damages would be inconsistent with the terms of the implied contract with all the shareholders. The second justification depends on the recognition of share capital as a guarantee fund for creditors.[44]

To the first of these contentions Professor Hornby replies that the judgments of Lords Cairns and Selborne show that they were fully alive to the existence of the company as a distinct legal entity and that the whole *ratio* of the case is the protection of the shareholders from a claim by one of their number that would be inconsistent with his contract with them.[45] However, the word 'protection' necessarily implies an adverse consequence and Professor Gower has very clearly demonstrated that the other shareholders cannot be placed in a worse position by one of their number being awarded damages without rescission than they would be if he rescinded and recovered damages.[46]

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42 (1880) 5 App. Cas. 317.
43 (1956) 19 M.L.R. 54, 61, 185.
44 Modern Company Law, 2nd ed., at 295.
45 *Op. cit.*, at 185.
46 *Ibid.*, at 61.

With respect, it is submitted that the confusion arises not from the failure to recognise a corporation as a legal entity distinct from its members, and thus not identical with an unincorporated partnership, but from the tendency to assume that all corporations are identical. For example, a partnership in Scots law is a separate legal entity from its members and so may have more points of similarity with an unlimited liability company than the latter has with a public limited liability corporation. Again, because of the restrictions on the transferability of its shares and the number of its members a proprietary company may well have more affinity with a partnership than with a public company. Now, it is a well established principle of partnership law that the partners may by agreement vary their rights, *inter se*, to any extent they desire, but that in so doing they cannot escape their individual liability to third parties.[47] However, once the partners have finalised their agreement it is equally well established that no individual partner can bring an action for damages against the partnership if he bases his cause of action on a breach of the duties imposed by that agreement. The reason for this restriction may not be logical but it is expedient.

Where such an action is brought against the partnership firm, the plaintiff will be one of those who will have to contribute to any damages awarded to him and this will entail a taking of the partnership accounts. The old rule of equity was that no action would lie, if it entailed the taking of the accounts as between the partners, unless dissolution was also claimed and, although this rule is now subject to certain exceptions, it still applies to claims for damages by a partner as such against the partnership as such. This was the decision in the comparatively recent case of *Mair* v. *Wood*,[48] an action *ex delicto*[49] against a partnership which under Scots law was a distinct legal entity. The important point is that where dissolution is ordered not only are the rights of the partners, *inter se*, adjusted by the taking of the accounts but so are the rights of the creditors. In other words, the partner's so-called lien is deferred to the rights of the firm's creditors but preferred to the rights of his co-partners' separate creditors.

Now, a perusal of all the judgments, except Lord Blackburn's, in the *Houldsworth Case* reveals that their Lordships did in fact apply this principle of partnership law to a contract of shareholding. Lord Selborne said:

> His complaint is that, by means of the fraud alleged he was induced to take upon himself the liabilities of a shareholder. The loss from which he seeks to be indemnified by damages is really neither more nor less than the whole aliquot share due from him on contribution of the whole debts and liabilities of the company; and if his claim is right in principle I fail to see how the remedy founded on that principle can stop short of going this length. But it is of the

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47 *Elkin & Co. Pty. Ltd.* v. *Specialised Television Installations Pty. Ltd.* (1961) 61. S.R. (N.S.W.) 165.

48 [1948] S.C. 83. Approved but distinguished in *Huston* v. *Burns* [1955] Tas. L.R. 3.

49 F.D. C.-S. please note.

> essence of the contract between the shareholders (as long as it remains unrescinded) that they should all contribute equally to the payment of all the company's debts and liabilities.[50]

With respect, it is submitted, that this line of reasoning fails to appreciate a vital distinction between partnerships and incorporated bodies. In the case of a partnership, provided that there has been no prior agreement to the contrary, if one of the partners is successful in claiming rescission, he can demand to have the whole partnership dissolved and the accounts taken. This in itself affords adequate protection for his co-partners and the firm's creditors. On the other hand, a company cannot be wound up merely because one of its shareholders succeeds in an action for the rescission of his shares. Therefore, when ever a shareholder rescinds, there is a possibility of some injury both to his fellow shareholders and the company's creditors.

If Lord Cairn's contention in *Tennent's Case*, that rescission is barred by insolvency, is correct then, *ex hypothesi*, rescission can never seriously harm the creditors and as rescission is not available neither are damages under the Committee's recommendations. On the other hand, to allow either rescission or damages for innocent misrepresentation during the continuance of the company's business raises many important questions of adjustment of competing claims that appear to be insoluble unless the company is wound up.

Professor Gower's second contention that the rule in *Houldsworth's Case* can be justified on the basis of the desirability of preserving the company's capital as a fund for the satisfaction of creditors, is in fact no more plausible than Professor Hornby's contention. Indeed, the justification of the proposition distorts the rule in supposing that it formulates a 'new' bar to rescission.[51] What the rule does in fact is to enunciate a new bar to damages. Clearly the effect of rescission and damages must result in a greater depletion of the capital fund than would an award of damages without rescission.

It is submitted, that the rule cannot be justified except where, as in *Houldsworth's Case*, rescission is barred either because of insolvency or winding-up. The rule is a result of the application of a well-established principle of partnership to a corporation which is not a partnership. Furthermore, *Mair* v. *Wood* applied a similar principle to a partnership, which in Scots law is a distinct legal entity[52] so that the mystique of

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50 (1880) 5 App. Cas. 317, 329. See also Lord Cairn's at 325 and Lord Hatherley at 333.

51 'Mr. Hornby admits that there is some justification for my view that the barring of the right of rescission is based on the principle of maintaining the capital.' Gower (1956) 19 M.L.R. at 62.

52 Partnership Act 1890 (Eng.), s. 4 (2). In Scotland a firm is a legal person distinct from the partners of whom it is composed, but an individual partner may be charged on a decree or diligence directed against the firm, and on payment of the debts is entitled to relief *pro rata* from the firm and its other members.

what Lord Halsbury called the 'real existence'[53] has no bearing on the rule. What does cause confusion is the continuing misconception that the Companies Acts have created one single legal concept, the trading corporation. In point of fact those Acts have created a variety of trading corporations, notably the public limited company, the proprietary limited company and the unlimited company. Although each of these have points of similarity, they also have many real distinctions so that in certain fields any attempt to formulate a rule applying to every type of trading corporation is more than likely to result in anomalies. As Atkin L.J. said, in *Re Wait*,[54] 'The difficulty illustrates the danger of seeking to conduct well established principles into territory where they are trespassers.'

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53 *Salomon* v. *Salomon Ltd.* [1897] A.C. 22, 33. It appears that Lord Halsbury had an inherent dislike of implying (except perhaps in his unfortunate adventures with the Australian Constitution) anything at all that was not actually written in a document. In *Smith* v. *Cooke* [1891] A.C. 297, 299, he said, 'If it is intended to have a resulting trust, the ordinary and familiar method of doing that is by saying so on the face of the instrument; and I cannot get, out of the language of this instrument, a resulting trust except by putting words that are not there.'

54 [1927] 1 Ch. 606, at 635.