Neutral Citation Number: [2021] EWCA Civ 795

Case No: A3/2020/0961

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE HIGH COURT OF JUSTICE
BUSINESS AND PROPERTY COURT ENGLAND AND WALES
BUSINESS LIST (ChD)
Mr Michael Green QC (sitting as a Deputy High Court Judge)
BL-2017-000429
BL-2018-002252

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 27th May 2021

Before :

LORD JUSTICE LEWISON
LORD JUSTICE ARNOLD
and
LORD JUSTICE EDIS

- -

Between :

CHALCOT TRAINING LIMITED	**Appellant**
- and -	
(1) MATTHEW ANTHONY RALPH	**1st Respondent**
(2) THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS	**2nd Respondent**

Between :

CHALCOT TRAINING LIMITED	**Appellant**
- and –	
(1) SUSAN ELIZABETH STONEMAN	**1st Respondent**
(3) THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS	**2nd Respondent**

Mr Laurent Sykes QC (instructed by **Lewis Silkin LLP**) for the **Appellant**
Mr Richard Vallat QC & Mr Jack Rivett (instructed by **HMRC Solicitor's Office and Legal Services**) for the **Respondent**

Hearing date : 18th May 2021

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Approved Judgment

Lord Justice Lewison:

Introduction

1. The main issue on this appeal is whether arrangements made between a company and its two employed shareholder/directors with a view to avoiding tax amounted to the allotment of shares at a discount; contrary to section 580 of the Companies Act 2006. There is a subsidiary issue: namely, whether the arrangements involved the payment of the company's shares or capital money in consideration of an agreement to subscribe for shares; contrary to section 552 of the Act.

2. The relevant arrangements were part of a commercially marketed tax avoidance scheme. It worked like this. The employee, typically the director and shareholder in an owner managed company, receives a payment (say £100) in return for offering to subscribe for shares (say 100 shares) with a nominal value of £1 per share (in aggregate £100). On receipt of the payment, the employee pays 1 p per share in return for which the shares are allotted as partly paid. The employee remains liable for the balance of 99 p per share. The balance is payable when called; and is deemed to have been called up in certain circumstances, for example if the company becomes insolvent, or the employee ceases to be employed by the company.

3. The idea underlying the scheme was that the company could deduct the £100 paid to the employee from its liability to corporation tax. That was because (a) it followed the accounting treatment; and (b) if and when the call was made, the proceeds would be credited to the company's capital account, rather than to its profit and loss account.

4. The tax consequences of the scheme are being tested in the tax tribunal; and form no part of this appeal. The company claims that the scheme contravened either or both of sections 580 and 552 of the Act; with the consequence that it is entitled to have the scheme set aside on the ground of mistake. Mr Michael Green QC (sitting as a judge of the Chancery Division) decided those issues against the company; but gave permission to appeal. His judgment is at [2020] EWHC 1054 (Ch), [2020] STC 1537.

5. HMRC oppose the appeal; although Ms Stonen and Mr Ralph do not. Mr Ralph has compromised the claim against him. We heard argument from Mr Sykes QC for the company and Mr Vallat QC for HMRC on the two points raised under the Companies Act. Having heard argument, we decided that we did not need to consider the question of mistake; and that we would dismiss the appeal with written reasons to follow. These are my reasons for joining in that decision.

The facts

6. I can take the relevant facts from the judge's careful judgment.

7. Chalcot Training Ltd ("the company") was established in 2005 by Mr Ralph and Ms Stoneman. Its business was to provide learning and communications products and services to large global organisations. From its inception, the company was owned 50/50 by Mr Ralph and Ms Stoneman and they were the only two directors. In May 2007, Mr Ralph and Ms Stoneman married.

8. In anticipation of profit growth, Mr Ralph and Ms Stoneman decided to explore tax planning. Their first steps were to transfer the company's business to a limited liability partnership that was called NKD Learning LLP ("the LLP"). The transfer happened gradually over the course of a year from October 2011.

9. In September 2011, through the company's accountant, Mr Ralph and Ms Stoneman were introduced to the E Shares scheme which had been developed and sold by Blackstar (Europe) Ltd ("Blackstar"). The E Shares scheme was designed to avoid corporation tax payable on the company's profits, which were intended to be the profits allocated by the LLP. This was to be achieved by payments being made out of those profits to employees in respect of their employment which was deductible for the purposes of corporation tax. The idea behind the scheme was that the payments to the employees would not be subject to PAYE, income tax or NIC because they did not constitute taxable earnings of the employees. This was because the payments were subject to the obligation of the employees to subscribe for shares in the employer, via the E Shares scheme. The E shares would each have a nominal value of £1.

10. On 28 November 2011, the company, Mr Ralph and Ms Stoneman entered into the first iteration of the E Shares scheme by signing various documents including agreements to subscribe for E Shares, board minutes and written resolutions of the shareholders ("the 2011 scheme"). By this first iteration, total payments of £2,180,000 were made to Mr Ralph and Ms Stoneman (£1,090,000 each) in the form of £10,900 paid into their respective bank accounts and the balance of £1,079,100 credited to their director's loan accounts. The £10,900 was immediately paid back to the company as being 1% of the nominal value of the E Shares that each had subscribed for. The remaining 99% of the nominal value of the E Shares remained uncalled. The payments made by the company were all made out of trading income.

11. Following the breakdown of their marriage, Mr Ralph resigned as a director of the company on 31 August 2012, and transferred his ordinary shareholding to Ms Stoneman.

12. On 19 November 2012, Ms Stoneman and the company entered into the second iteration of the E Shares scheme with the amount of £2,230,000 being put through the scheme ("the 2012 scheme"). As with the first iteration, 1% of that amount, £22,300, was paid to Ms Stoneman and immediately paid back by her to the company as payment of 1% of the nominal value of the 2,230,000 E Shares allotted to her. The balance of £2,207,700 was credited to Ms Stoneman's loan account with the company. This sum was never paid out by the company to Ms Stoneman.

13. On 1 July 2013, Ms Stoneman caused the company to use the E Shares scheme for the third and final time ("the 2013 scheme"). This time the shares allotted were actually called F Shares but the terms were the same. The sum paid to Ms Stoneman was £1,725,000, with the 1% amount paid back to the company being £17,250, and the balance of £1,707,750 credited to Ms Stoneman's loan account.

14. In March 2015, HMRC opened an enquiry into the company's tax returns and on 17 February 2016 issued a number of determinations in respect of PAYE, income tax and NIC in a total amount of approximately £3.89 million plus interest. The company has appealed those determinations to the FTT but they are presently stayed pending the resolution of these proceedings.

15. Ms Stoneman has attempted to effect a reversal of the E Shares scheme at least insofar as she is concerned; and in order to support the company's position in these proceedings. She has therefore repaid the money that she actually received from the company under the 2011 scheme and has cancelled the credits that were applied to her loan account under the 2012 and 2013 schemes. She has also invited HMRC to cancel the corporation tax deductions that the company made as part of the E Shares scheme but HMRC maintain that such deductions were properly made because the payments should be characterised as remuneration not distributions.

The scheme documentation

16. On 25 November 2011, Blackstar provided various documents for execution by Mr Ralph and Ms Stoneman in order to effect the 2011 E Shares scheme. On 28 November 2011, those documents were executed. They were as follows:

    i) Minutes of a board meeting approving the creation of E Shares and the entry into the contracts to subscribe for the E shares;

    ii) Written resolution of the company's shareholders adopting new articles of association and authorising the company to enter into contracts "facilitating the subscription" for the E Shares by Mr Ralph and Ms Stoneman. There was also a consent form signed by Mr Ralph and Ms Stoneman to the variation of their rights as holders of the ordinary shares in the company to the creation of the new class of E shares;

    iii) Agreements between the company and each of Mr Ralph and Ms Stoneman "to subscribe for Class E shares", to which was attached a "Form of Application for Class E Shares" .

17. At the same time, the company adopted articles of association which incorporated Regulation 19 of Schedule 1 to the Companies (Model Articles) Regulations 2008. That provided as follows:

    > "(2) Directors are entitled to such remuneration as the directors determine -
    >
    > (a) For their services to the company as directors, and
    >
    > (b) For any other service which they undertake for the company
    >
    > (3) Subject to the articles, a director's remuneration may–
    >
    > (a) take any form…"

18. In order to accommodate the creation of the E shares, the company's articles of association had to be specifically amended. The amended articles provided (so far as relevant):

    > "3.6 E Shares shall not carry any right to vote
    >
    > 3.7 E Shares shall not carry any right to receive notice of or to attend any meeting of the shareholders of the Company

3.8 On a winding up of the Company and only to the extent that there are assets available to be to be [sic] distributed to the shareholders of the Company each E share shall only be entitled to receive a payment of 1p but such payment shall rank in priority to the payment in respect of other classes of share

3.9 The directors may pay a dividend on the E Shares but where a dividend is paid on any other class of share there shall not in consequence be an entitlement for the holders of the E Shares to require any dividend to be paid in respect of the E Shares

…

3.12 E Shares may only be transferred with the unanimous consent of the directors of the Company

3.13 E Shares shall be allotted 1p paid, 99 p uncalled

3.14 The Company may by giving notice to the holder of an E Share make a call for the full amount previously uncalled or for any part of the amount previously uncalled. The amount called shall be due for payment on the ninetieth day following the date of the notice…

3.15 Any amount uncalled in respect of an E Share shall be treated as called in full and payable immediately upon the appointment of a liquidator of the Company

3.16 In the event that calls are not paid when due to be paid the holder of the share may be required to forfeit his E Share but for the avoidance of doubt the Company reserves its right fully to pursue by all lawful means the payment of any called but unpaid amounts."

19. The agreement to subscribe for E shares provided (so far as relevant):

"**B Whereas:**

(a) The Employee is employed by the Employer ;

(b) As part of the employment arrangements between the Employer and the Employee and in particular in recognition of the services of the Employee during the period ended 31 March 2012 the Employer is willing to assist the Employee to subscribe for Class E shares of the Employer on the terms more particularly set out below; and

(c) Class E shares are to be £1 shares with an initial called up amount of 1p with 99p uncalled.

C Now It Is Hereby Agreed:

C.1 In consideration of the Employee offering to subscribe for Class E shares substantially in the form of the offer to subscribe set out in the schedule to this agreement ("the Offer") and subject to the Employee complying with the further terms set out below ("the Terms") the Employer shall pay to the Employee a sum of £10,900 followed by a sum of £1,079,100 ("the Payments") which sums shall when paid be non-refundable.

C.2 The sum of £10,900 shall be applied by the Employee in making the Allotment Payment as described in the Offer.

…

C.4 The payment of the sum of £1,079,100 shall take place immediately following the payment of the sum of £10,900 described in clause C.1 and shall be made by the payment sum being applied as a credit to the Employee's loan account with the Employer…

D The Terms

D.1 The Employee shall not withdraw the Offer prior to acceptance by the Employer.

…

E Impact on Employment Contract and Effective Law

E.1 The rights granted to the Employee under this Agreement shall not afford the Employee any rights or additional rights to compensation or damages in consequence of the loss or termination of the Employee's office or employment with the Company for any reason whatsoever and whether any such termination is subsequently held to be wrongful or unfair…"

20. A schedule to the agreement contained the offer referred to in clause C.1 of the subscription agreement. It added "cessation of employment" to the two situations when calls could be made as specified in the articles; as follows:

"**Calls**

1. On Notice

…

2. On the appointment of a liquidator of the Company

…

3. On Cessation of employment with the Company

> At any time whilst I am the holder of a Class E share any amount uncalled in respect of the share shall be treated as called in full and payable immediately should I, at any point during the period, be neither an employee nor an officer of the Company."

21. The amount paid to Ms Stoneman and Mr Ralph on the first iteration of the scheme was recorded in the company's accounts under the heading of "Director's remuneration"; and in the Schedule of Administrative Expenses as "Directors' employment expense". Both Ms Stoneman and Mr Ralph signed Directors' Emolument Certificates in which it was stated that:

> "The emoluments received by me in respect of my services to the company were £1,193,071, excluding pension contributions."

22. At the company's AGM a resolution was passed approving "director's remuneration as shown in the accounts".

23. The accounting treatment was the same in the two subsequent years.

What the judge decided

24. The judge had to decide a number of issues, many of which are no longer relevant to this appeal.

25. At [115] he said that no one could read the accounts, let alone sign them, without appreciating that the payments were being treated as at least related to directors' remuneration. They were "payments to directors/employees in their capacity as such". One of the issues before the judge was whether the payments were unlawful distributions to shareholders (an argument no longer pursued on this appeal). It was principally in connection with that issue that the judge considered the proper characterisation of the payments. It was common ground before him that labels applied to transactions were not determinative of their true nature.

26. The judge considered a number of authorities; and summarised his conclusions about the law at [166]. He then applied the principles he had formulated to the facts as he found them. He began by considering the purpose of the E shares scheme and made observations which are relevant to the issues on this appeal. What he said was:

> "[170] The purpose of the E Shares scheme was twofold: (a) to avoid corporation tax on the profits being made by the business; and (b) to enable tax-free payments to be made to Ms Stoneman and Mr Ralph. They were the only shareholders and directors of the Company. After Mr Ralph's resignation as a director on 31 August 2012, Ms Stoneman was the Company's sole director.
>
> [171] In order to achieve the corporation tax deduction, the payments and credits had to be allowable expenses. While they did not necessarily have to be remuneration as such, it was common ground that the arrangements as a whole had to be "employment-related". If the payments and credits were actually

> distributions to shareholders, they would not be deductible for corporation tax purposes. Lawful dividends are paid out of a company's post-tax profits. It was therefore imperative for the corporation tax purpose that the payments and credits were not distributions and were made to Ms Stoneman and Mr Ralph in their capacity as directors and/or employees and in reward for their services to the Company.
>
> [172] In order that the payments would not attract income tax or NIC, the recipients had to be subject to a concomitant obligation which was that they had to subscribe for the E Shares with a contingent liability to pay up the full nominal value of the E Shares. Whether the E Shares scheme was effective for such purpose is a matter for the FTT proceedings, not me. What is relevant for me is that the payments and credits themselves had to be a form of remuneration that would otherwise be taxable as the recipient's earnings.
>
> [173] It was necessary therefore for both purposes of the E Shares scheme for Ms Stoneman and Mr Ralph to be receiving the payments in their capacity as directors or employees; it was not necessary for them to be shareholders in the Company."

27. He then turned to consider the documentation for the E shares scheme. He pointed out at [179] that if the agreement was considered to be in substance a subscription agreement it was very uncommercial for all parties. He said at [180] that if that was all that they were about, they would not have been entered into. He went on to say:

> "While there was a theoretical liability on the call, which they anticipated being avoided (despite Ms Stoneman's alleged lack of belief in there being an effective exit strategy), the reality was that they had the money from the Company and could use it as they pleased, like any other form of remuneration."

28. He concluded at [181]:

> "Therefore, the substance of the Agreements and looking at them as a whole and in context confirms that they were part of the "*employment arrangements*" and were a means of rewarding Ms Stoneman and Mr Ralph for their services to the Company. The coupling of those rewards with an obligation to subscribe for the E Shares was the mechanism for achieving the tax purpose of the scheme but, in my view, that obligation does not detract from the true nature of the payments."

29. He went on to consider the accounting treatment of the payments, concluding at [185]:

> "It was of course critical for the whole success of the E Shares scheme that the accounts recorded the payments as remuneration, that such remuneration was subject to an obligation to subscribe for the E Shares and that the

> remuneration would be deductible for corporation tax. That would be the basis for the Company's tax return. There was no point doing the E Shares scheme unless the payments were so regarded. There is no doubt that the accounts recorded the payments as remuneration."

30. At [189] he said that remuneration does not cease to be remuneration because it is coupled with an obligation to subscribe for E shares. At [200] he said:

> "The directors, who owned the Company, were able to decide that the Company should reward them by the payment of a substantial form of remuneration. It does not matter if it is called a bonus, a benefit in kind, salary or any other type of remuneration. For the purposes of the E Shares scheme and in order to achieve its purpose, they decided to pay themselves by way of remuneration rather than dividend and this was in recognition of their services to the Company."

31. At [219] he held that all the relevant individuals concerned considered that the payments were remuneration for services to the company.

32. His ultimate conclusion on the character of the payments was at [221]:

> "I consider that the directors' power to award themselves remuneration was properly and genuinely exercised for the purpose of effecting the E Shares scheme. It was done with the benefit of professional advice. The Company was solvent and able to pay such remuneration without affecting creditors or any other third parties. The Company does not argue that this was excessive remuneration in the sense that a smaller figure would have been acceptable…. The Company says simply that the payments were not a reward for any services provided and were purely paid as consideration for the subscription of the E Shares. I disagree with that analysis of the Agreement and the nature of the payments. It was within the power of the directors and shareholders of the Company to authorise the payment of remuneration in that form. As it was a genuine exercise of that power, the payments were not disguised distributions to shareholders."

33. Having reached that conclusion the judge turned to consider whether the shares had been allotted at a discount. At [238] he held that a company cannot agree to accept less than the nominal value of shares that it issues. It does not matter that shares remain unpaid in respect of some of their nominal value so long as the shareholder remains liable to a call for the unpaid amount. That led to the conclusion at [239]:

> "Accordingly, on the facts of this case, the unpaid 99p on the E Shares cannot constitute a discount within the meaning of s.580 of the Act. I do not think that s.580 is intended to cover payments made by the company to the proposed allottee. It is simply concerned with the obligation of the allottee to pay, whether in

> cash or otherwise, the full nominal value of the shares and it does not matter which money is used for that purpose."

34. He went on to hold that the payments to Ms Stoneman and Mr Ralph were the result of a genuine exercise of the directors' power to award remuneration; and that the fact that the remuneration was coupled with an obligation to subscribe for the shares made no difference. As he put it at [253]:

> "They remained liable to a call for the full nominal value of the E Shares. There can be no question of the E Shares having been issued at a discount within s.580 of the Act."

35. He held further that the payments were not payments of the company's shares or capital money in consideration of an agreement to subscribe for shares. He encapsulated his reasoning on that topic at [258]:

> "The Company's case appears to be that the whole of the payments and credits to Ms Stoneman and Mr Ralph under the E Shares schemes was a "*commission*" paid out in consideration of Ms Stoneman and Mr Ralph agreeing to subscribe for the E Shares. Quite apart from the fact that it was actually remuneration rather than "*commission*", the Company cannot establish that the payments and credits were an application of the Company's "*shares or capital money* "as defined by Lord Davey. More fundamentally, the payments and credits were not required to be "*repaid*" to the Company - Mr Sykes QC submitted that they were akin to an interest-free loan – and the money could be used by Ms Stoneman and Mr Ralph as they wished, for instance in buying the Ibiza property. The payments and credits were necessarily paid out of the Company's profits (that is why it got the corporation tax deduction) and I do not see how the Company can prove that they came from the "*shares or capital money*" arising out of the E Shares scheme. The Company will receive the "*capital money*" only after a call has been made."

36. He went on to say at [260]:

> "If however the Company failed on the characterisation issue, as it has, then that would necessarily deal a fatal blow to any argument around ss.580 and 552, because the payments and credits were genuine remuneration and cannot amount to a discount on the E Shares or a commission for the agreement to subscribe for the E Shares. In any event, their claim in such respect was wrong in law and on the facts for the reasons set out above."

37. Those conclusions, I think, meant that the company's claim to set aside the transactions on the ground of fundamental mistake failed. Nevertheless, the judge went on to consider whether the elements of a claim in mistake could have been made out. He

directed himself by reference to the summary of the law in *Great Peace Shipping Ltd v Tsavliris Salvage (International) Ltd* [2003] QB 679, 703:

> "… the following elements must be present if common mistake is to avoid a contract: (i) there must be a common assumption as to the existence of a state of affairs; (ii) there must be no warranty by either party that that state of affairs exists; (iii) the non-existence of the state of affairs must not be attributable to the fault of either party; (iv) the non-existence of the state of affairs must render performance of the contract impossible; (v) the state of affairs may be the existence, or a vital attribute, of the consideration to be provided or circumstances which must subsist if performance of the contractual adventure is to be possible."

38. Having considered the facts, he concluded at [285]:

> "Therefore, in my view, the Company can establish elements (iv) and (v) but I doubt if it can establish (i), (ii) and (iii). As expressed above in relation to elements (ii) and (iii) I have serious reservations about the availability of a remedy in mistake in the circumstances of this case, where there is not an arm's length transaction and there are other adequate remedies available to deal with the consequences of the payments and credits being unlawful."

The issue of shares at a discount

39. Section 580 of the Companies Act 2006 provides:

> "(1) A company's shares must not be allotted at a discount.
>
> (2) If shares are allotted in contravention of this section, the allottee is liable to pay the company an amount equal to the amount of the discount, with interest at the appropriate rate."

40. A similar principle applied before the prohibition on issuing shares at a discount was first made explicit in company legislation. In *Welton v Saffery* [1897] AC 299, 327 Lord Davey explained what issuing shares at a discount meant:

> "Let us ask, what is really meant by the issue of a share at a discount? It means that although less than the nominal amount, or even (as in the case of the bonus shares) nothing whatever, has been paid up on the share, it is to be treated for all purposes of the company, and to be placed on the same footing as regards the rights of the shareholders, as if it had been fully paid up in cash."

41. He repeated the point in *Hilder v Dexter* [1902] AC 474, 479:

> "… shares could not be issued at a discount, i.e., subject to an agreement that the shareholder should pay less to the company than the nominal value of the share."

42. Before changes made by the Companies Act 2006 it was unlawful for a company to give financial assistance for the purchase of its own shares. But that prohibition now only applies to public companies; so does not affect this case. But that general prohibition does underpin the reasoning in many of the older cases.

43. The idea behind the limited liability company is that people will be encouraged to be associated in a business enterprise if they are able to limit their personal liability for the debts of the enterprise. The way in which this is achieved is by the creation of a corporation with limited liability. What that means is that the personal liability of the members of the company is limited to the amount that they have subscribed or agreed to subscribe to the capital of the company. The capital in this instance is the company's nominal share capital. It is part of the very definition of a limited company in section 3 of the Companies Act 2006. That provides that a company is a company limited by shares if the liability of its members "is limited to the amount, if any, unpaid on the shares held by them." This fundamental feature of corporate liability has been recognised for a very long time. It was introduced by the Joint Stock Companies Act 1856; and repeated in the Companies Act 1862. As it was put in early editions of Buckley on the Companies Acts:

> "The dominant and cardinal principle of these Acts is that the investor shall purchase immunity from liability beyond a certain limit, on the terms that there shall be and remain a liability up to that limit."

44. The critical question, then, is whether the investor remains liable up to the limit represented by the nominal value of a share. This is known as the principle of capital maintenance.

45. In *Ooregum Gold Mining Co of India Ltd v Roper* [1892] AC 125 the House of Lords considered this point. The company in that case had a share capital of £125,000 divided into 125,000 shares of £1 each. It ran into financial trouble; and the value of its shares had declined to 2s. 6d. In an effort to raise new capital, an EGM approved a resolution for the issue of 120,000 preference shares of £1 each, to be credited in the capital and books of the company as having the sum of 15s. per share paid thereon. Thus the liability of each shareholder to contribute to the capital of the company was only 5s. The 15s was neither paid nor payable. The House of Lords held that the allotment of shares on those terms was unlawful.

46. All the Law Lords (with the possible exception of Lord Herschell) agreed that the philosophy stated in Buckley encapsulated the philosophy underlying limited liability. It was that philosophy that entailed the prohibition on a company issuing shares at a discount to their nominal value. Lord Halsbury LC said at 133:

> "It seems to me that the system thus created by which the shareholder's liability is to be limited by the amount unpaid upon his shares, renders it impossible for the company to depart from that requirement, and by any expedient to arrange with their

> shareholders that they shall not be liable for the amount unpaid on the shares, although the amount of those shares has been, in accordance with the Act of Parliament, fixed at a certain sum of money."

47. Lord Watson said at 136:

> "In my opinion, these enactments read together indicate the intention of the Legislature that every member who takes shares from the company in return for cash shall either pay or become liable to contribute their full nominal value. The "amount, if any, unpaid," obviously refers to the "fixed amount" of the shares into which the capital is divided, as set forth in the memorandum, and not to any lesser amount which may be agreed upon between the company and its shareholders; and the statutory liability of each shareholder is for the difference between the amount fixed by the memorandum and the sum which has actually been paid upon his shares. Consequently, if shares are issued against money, it appears to me that any payment to the company less than the nominal amount of the share must, by force of the statute, and notwithstanding any agreement to the contrary, be treated as a payment to account, the member remaining liable to contribute the balance, when duly called for."

48. He added:

> "A company is free to contract with an applicant for its shares; and when he pays in cash the nominal amount of the shares allotted to him, the company may at once return the money in satisfaction of its legal indebtedness for goods supplied or services rendered by him. That circuitous process is not essential. It has been decided that, under the Act of 1862, shares may be lawfully issued as fully paid up, for considerations which the company has agreed to accept as representing in money's worth the nominal value of the shares. I do not think any other decision could have been given in the case of a genuine transaction of that nature where the consideration was the substantial equivalent of full payment of the shares in cash."

49. Lord Macnaghten said at 144:

> "But all this legislation proceeds on the footing of recognising and maintaining the liability of the individual members to the company until the prescribed limit is reached. The memorandum of association of a company limited by shares must contain "the amount of capital with which the company proposes to be registered divided into shares of a certain fixed amount." It must also contain "a declaration that the liability of the members is limited." Neither the liability nor the limitation is defined in the memorandum itself. And so the declaration carries you back to the earlier part of the section, where you are told what is meant

> by "a company limited by shares." It is a company "formed on the principle of having the liability of its members limited to the amount unpaid upon their shares." That must mean that the liability of a member continues so long as anything remains unpaid upon his shares. Nothing but payment, and payment in full, can put an end to the liability."

50. The prohibition on issuing shares at a discount to nominal value thus long pre-dated section 580. Although it was described as a "common law" prohibition, it is, I think, more accurately described as inevitably flowing from the statutory machinery for the creation of a limited liability corporation.

51. Mr Sykes illustrated the scope of this principle by reference to other decided cases.

52. In *Eddystone Marine Insurance Co* [1893] 3 Ch 9 a company had been trading as a private company. It was decided to invite subscriptions from the public. But before doing so it resolved to allot 300 shares of £20 each in the company to named allottees, to be credited in the company's books as fully paid up and free from any liability for such payment. There was some mention of the shares having been allotted because the company was indebted to the allottees for services rendered. At first instance Wright J said at 13:

> "With regard to the first question, the only thing amounting to anything like evidence of payment is the registered agreement itself, where it is said that the company were indebted to those gentlemen for services rendered and so forth; but I cannot help coming to the conclusion that on the true view of the facts there never was anything in the nature of payment for these shares."

53. He regarded the explanation given as, in effect, untrue. In the Court of Appeal Lindley LJ said at 17:

> "They did not contemplate appealing to the public to take up a large issue of shares, and they came to the conclusion that they all might have some paid-up shares for nothing. They resolved by special resolution which was duly confirmed to give each other and to allot to each other fully paid-up shares for nothing. I say distinctly for nothing, because, having gone through the correspondence with Mr. Jordan, and having seen how the expression "in consideration of services" got into the contract, it is obviously a mere blind."

54. The question that he posed (and answered in the negative) was:

> "Can a limited company give its members fully paid-up shares for nothing, so that when the company is wound up those shareholders are not liable to pay calls in respect of those shares?"

55. Lopes LJ said that the allotment was "in truth and in fact … nothing more than a mere gift." AL Smith LJ also treated the question as one of fact. As he put it at 20:

> "Now that issue of fact had to be tried by the learned Judge, and in my judgment he is perfectly right in the conclusion he has arrived at. He came to the conclusion that these shares had been given by the company to these two gentlemen, and that there were no services rendered or expenses incurred as consideration for this gift, in fact, that there was neither money nor money's worth given by these two gentlemen for the shares."

56. I do not doubt that if, on the facts, shares are credited as fully paid, but are in fact given to the allottee, they are issued at a discount. The finding of fact was that there had been nothing "in the nature of payment"; and the terms of the allotment purported to exclude any future liability to contribute to the company's capital. But that is not this case. In this case the judge's finding of fact was that the payments were remuneration; and Ms Stoneman and Mr Ralph remained liable to pay calls when called upon to do so.

57. In *Metropolitan Coal Consumers' Association v Scrimgeour* [1895] 2 QB 604 the company agreed with a firm of brokers to pay commission for procuring applications for shares. When the company was in the course of winding up, the liquidator applied to recover the amount of the commission on the ground that the shares had been issued at a discount. That argument received very short shrift in this court, where the Respondents were not even called on. Lindley LJ said at 606:

> "This is an attempt to push some sensible and well-recognised doctrines of this Court to an absurdity. The law is clear that limited companies cannot issue shares at a discount. What is the meaning of that? The meaning of that is that shares cannot be issued upon terms which are inconsistent with the provisions of the statutes relating to limited companies; or, in other words, the statutes having said that every holder of a share shall pay so much for it, the company cannot issue the share upon the terms that the shareholder shall pay less. That is the whole of the theory of issuing shares at a discount."

58. All three judges held that a payment of commission in good faith to brokers did not contravene the prohibition, any more than advertising the share offer in a newspaper would have. Although, as Mr Sykes pointed out, Lindley LJ acknowledged that apparent transactions might be manipulated to as to result in the issue of shares at a discount, it is clear from a later part of his judgment that what he was referring to was an arrangement that he described as "a juggle". Once again, the key to the issue of shares at a discount is that the shareholder is not liable to pay the full amount of the nominal value of the share.

59. In *Hong Kong and China Gas Co Ltd v Glen* [1914] 1 Ch 527 Mr Glen had a concession to supply gas to Hong Kong. He agreed to transfer his concession to the company on the terms of an agreement. The agreement provided that if the company's paid up capital were to increase above £20,000, then the company would allot him shares equal to one fifth of the increased capital; and "will pay to him … a sum equal to the nominal amount of the shares so allotted to him…, which sum or sums so paid shall from time to time be immediately applied in paying up in full the shares so allotted." In order to understand the decision, it is important to appreciate the company's argument. Mr Younger QC, for company, encapsulated the company's complaint at 532:

> "In article 7 of the agreement the real consideration for the sale of the concession is shewn. That is to be 400 shares of 10l. each. These are to be allotted to the vendor, and contemporaneously 4000l. is to be placed by the company in the hands of a nominee of the company and a nominee of the vendor, who are immediately to apply the 4000l. in paying up in full the 400 shares. *We are not complaining of that*, but of the provisions of article 8, under which, on every increase of capital beyond a fixed amount, a fifth of the new shares are to be allotted to T. Glen, or his personal representatives or assigns, and the process of paying up these shares in full with money provided by the company is to be repeated. The net result of the two operations is that out of every issue of 20,000l. new capital the company gets only 16,000l., while the vendor gets 4000l. in fully-paid shares without paying or giving any consideration for them." (Emphasis added)

60. It is important to note that the company was not complaining about the money to pay for the shares having come from the company. The complaint was that the actual nominal share capital of the company would be less than it appeared to be. That is precisely how Lord Davey characterised the issue of shares at a discount.

61. Mr Glen's executors argued that the obligation to allot the shares was part of the consideration for the original transfer of the concession; but Sargant J rejected that argument. He pointed out that the obligation was indefinite in time and could apply whenever the company increased its capital irrespective of the reason why it did so. Nevertheless, he held that the obligation to allot the shares was valid. What was invalid was the company's obligation to provide Mr Glen with the funds to take up the allotment. What he said about the interpretation of the agreement at 538 was this:

> "When, however, the clause is carefully examined, I cannot think that it tends less to contravene the statutory provisions as to the capital of companies than if it were a clause providing in terms for the issue of fully-paid shares. For, while the first part of the article contains an obligation to allot to Thomas Glen or his nominees one-fifth of all increased share capital, the second part of the article provides that, contemporaneously with such allotment, the company shall furnish cash equal to the full nominal value of the shares, and earmarks and dedicates that cash, so that it has immediately to return to the company's coffers for the purpose of paying up the very shares in full. It is impossible, in my view, to hold that the second part of article 8 does not amount to a contract for the contemporaneous absolution and discharge of the allottee from his prima facie statutory liability to provide the nominal value of his shares in money."

62. Once the obligation to allot the shares was decoupled from the price paid for the transfer of the gas concession, it is not difficult to see how the judge came to the view that the money was simply moving round in a circle. But I do not consider that the mere fact that the money with which to pay for the shares came from the company was the crux

of the decision. That, after all, was not the company's complaint. What was important, however, was that as a matter of construction of the agreement its effect was to discharge Mr Glen from what would otherwise have been his obligation to contribute to the company's capital. In the present case Ms Stoneman and Mr Ralph were free to do as they pleased with the money. If and when they were called upon to contribute the unpaid capital on the E shares it was up to them to find the funds to do so. Unlike *Glen*, this is not a case in which the payment was earmarked and dedicated to paying the calls. Indeed, it is possible that the payments made to Mr Glen would, nowadays, be regarded as having been impressed with a *Quistclose* trust (see *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567).

63. In *Australian Investment Trust Ltd v Strand and Pitt Street Properties Ltd* [1932] AC 35 the Investment Trust underwrote a share issue at a commission of 1s. per share. As I understand the agreement, it was granted the right to apply for the allotment of 60,000 shares the nominal value of which was to be set off against the company's liability to pay commission. Giving the opinion of the Privy Council Lord Tomlin said at 746:

> "Now it is not disputed that an agreement by a company to pay a commission to a person in consideration of his subscribing in praesenti for a definite number of shares in the company's capital would be ultra vires the company. It would in effect be an arrangement whereby he was allowed a rebate or discount on the amount payable by him for the shares for which he agreed to subscribe."

64. Lord Tomlin then applied the test laid down in *Ooregum*. He said:

> "What are the services rendered by the underwriter in return for the commission over and beyond his agreement to subscribe for shares? In their Lordships' opinion the answer must be that there are none."

65. The essential point that Mr Sykes makes on behalf of the company is that in deciding whether shares have been allotted at a discount to nominal value, you must take into account any payment made by the company to the subscriber in order to subscribe. Thus, he says, if the company pays someone £100 "to subscribe for shares" with a nominal value of £100, the company is not getting in the required nominal value.

66. In his skeleton argument Mr Sykes put forward the proposition that on the facts of this case the company would never get in the full amount of the nominal share capital attributable to the E shares. I do not follow that proposition. It is contradicted by the articles of association; and by the form of application for the shares. In relation to each £1 share the allottee remained liable to pay the whole amount of capital uncalled; viz. 99p; either on one of the events specifically mentioned, or following a call by the company. There was no question of any reduction or set-off in relation to the amount of capital uncalled. Unlike Mr Glen, therefore, Ms Stoneman and Mr Ralph were not discharged from their respective obligations to contribute to the company's capital as and when called upon to do so.

67. To a large extent the answer to the point depends on what the payment by the company to Ms Stoneman and Mr Ralph was; and out of what funds it was paid. If, as the

documents suggested, and the judge found, it was an exercise by the board, in good faith, to award remuneration, then the payment cannot be said to have been a payment "to" subscribe for shares. It was remuneration, which the payees were free to do with as they wished, apart from the 1p which they had contractually agreed to pay as part payment for the shares. But as to the remaining 99p per share they remained liable to pay it to the company, from their own funds, if and when a call was made; and in any event if they left the company or the company went into liquidation.

68. The judge held that his finding that the payments were genuine exercises of the power to award remuneration meant:

> "[they] cannot amount to a discount on the E Shares or a commission for the agreement to subscribe for the E Shares."

69. Mr Sykes sought to escape from this by submitting that the judge had wrongly conflated the question whether the payments were a distribution (which did not depend on the contractual position) and the question whether there was good contractual consideration for the payments (other than the agreement to subscribe for the shares). The starting point here must be the fact that the agreement pursuant to which the payments were made described the payees as employees employed by the company; and the accounts recorded the payments as directors' emoluments. They were not, therefore, in the position of directors who merely held office. The judge found at [220] that the payments made to Ms Stoneman and Mr Ralph were to be characterised in the way that they were described in all the documentation and the accounts; namely as a form of remuneration in recognition of their services as "directors and employees".

70. Mr Sykes argued that past services performed by Ms Stoneman and Mr Ralph could not have amounted to valid contractual consideration for the payments to them. I do not think that that is the right way of analysing what happened. Directors take up office on the terms of the articles of association: see e.g. *In Re Anglo-Austrian Printing and Publishing Union. Isaacs' Case* [1892] 2 Ch. 158; *New British Iron Co ex p Beckwith* [1898] 1 Ch 324. The company's obligation is to pay the director the remuneration and benefits provided by the articles for the directors. Whether a director has any right to remuneration therefore depends on what the articles say. As mentioned, the company's articles of association provided that:

> "(2) Directors are entitled to such remuneration as the directors determine -
>
> (a) For their services to the company as directors."

71. The articles are framed in the language of entitlement. If someone is entitled to something, it usually means that they have a legal right to it. It follows from this, in my judgment, that as and when directors performed services for the company, they did so on the legally binding basis that the directors would exercise the power of determination given to them by the articles in a rational manner and in good faith: see, by analogy, e.g. *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287, [2005] ICR 402. Once remuneration has been declared under that article, it is a debt for which a director can sue: see e.g. *Orton v Cleveland Fire Brick and Pottery Co Ltd* (1865) 3 Hurl & C 868. It is no different, in my judgment, from the case of an employee whose contract of employment provides for the employer to have an (apparently) unfettered

discretion to decide whether or not to award that employee a bonus. The decision will, in practice, be taken after the period of service that the bonus is designed to cover; but I do not consider that that makes the services past consideration. Moreover, section 1299 of the Act provides that the Act extends to the whole of the United Kingdom. The English principle that past consideration cannot be valid contractual consideration has no counterpart in Scotland: *Park Business Interiors Ltd v Park* [1992] BCLC 1034, 1041. It would (to put it no higher) be odd if what was permitted in Scotland were prohibited in England when both English and Scottish courts apply the same statutory provision.

72. Quite apart from that, it seems to me that the question is not whether there was good consideration for the payment; but whether there was good consideration for the shares. If one asks what consideration is being given for the shares, the answer is: cash. 1p is paid immediately and the remaining 99 p is payable when called. For every £1 share the allotee pays precisely £1. So the company's issued share capital represents the amount of cash which it has received or is entitled to receive in exchange for the shares.

73. In addition, the mischief against which section 580 is directed (as confirmed by all the cases that we have been shown) is the depletion of the company's nominal share capital. The link between issuing shares at a discount and a company's share capital was made by Lord Macnaghten in *Welton v Saffery* at 322:

> "The issue of shares at a discount is just as much an unauthorized reduction of capital as the purchase by a company of its own shares."

74. If a payment is made (as in this case) out of what would otherwise have been a company's trading income which would have been taken into account in its computation for corporation tax purposes, it does not fall within the mischief against which section 580 is directed. Thus in *IRC v Blott* [1921] 2 AC 171, 183 Viscount Haldane said:

> "Nowhere in [the Companies Acts] is there any provision restricting its capacity, if the memorandum of association permits of it, to apply funds, which form no part of its share capital, but are surplus profits at its disposal, in providing for the benefit of shareholders who desire to take up unissued capital the funds requisite for so doing, and to apply such funds directly to the purpose."

75. He added at 184:

> "I think that it is, as matter of principle, within the power of an ordinary joint stock company with articles such as those in the case before us to determine conclusively against the whole world whether it will withhold profits it has accumulated from distribution to its shareholders as income, and as an alternative not distribute them at all, but apply them in paying up the capital sums which shareholders electing to take up unissued shares would otherwise have to contribute."

76. Mr Sykes' argument, if correct, would have startling consequences. The argument is that either the 99p per share which was left unpaid was a discount; or that the whole of the 100p per share was a discount. If section 580 applies, then the payee would have to pay the discount to the company under section 580(2). So the payee would be required to pay the company either 99p or 100p per share. But Mr Sykes accepted that the repayment does not discharge the obligation on the payee to pay 1p per share immediately or the remaining 99p as and when called. Far from relieving the allottee from liability to contribute cash to the company's capital account, the consequence of the argument is that they would have to pay twice. It cannot have been Parliament's intention that the company would be entitled to double recovery.

77. I would hold, therefore, in agreement with the judge, that the shares in question were not allotted at a discount to their nominal value.

Prohibited commission

78. The second way in which Mr Sykes puts the case is that the payments were (or included) an unlawful discount in contravention of section 552. Section 552 of the Companies Act 2006 provides:

> "(1) Except as permitted by section 553 (permitted commission), a company must not apply any of its shares or capital money, either directly or indirectly, in payment of any commission, discount or allowance to any person in consideration of his—
>
> (a) subscribing or agreeing to subscribe (whether absolutely or conditionally) for shares in the company, or
>
> (b) procuring or agreeing to procure subscriptions (whether absolute or conditional) for shares in the company.
>
> (2) It is immaterial how the shares or money are so applied, whether by being added to the purchase money of property acquired by the company or to the contract price of work to be executed for the company, or being paid out of the nominal purchase money or contract price, or otherwise.
>
> (3) Nothing in this section affects the payment of such brokerage as has previously been lawful."

79. It is not suggested by either side that section 553 applies. Nor did Mr Sykes argue that there was a commission involved. He said that a "discount" in section 552 had the same meaning as in section 580, except that whereas section 580 was concerned with a discount from nominal share value, the discount in section 552 was a discount from what would justly be due from the subscriber.

80. In our case, there never was any question of issuing the shares except at their nominal value. So I do not consider that the difference between a discount from nominal value and a discount from what would justly be due from the subscriber has any impact on what we have to decide.

81. The House of Lords considered a predecessor of section 552 in *Hilder v Dexter* [1902] AC 474. Mr Hilder applied for and was allotted shares in a company at par with an option exercisable for one year of taking up further shares at par. By the time that he exercised his option the shares had a market value of more than twice their nominal value. The question was whether it was lawful to allot shares at less than market value. The lower courts, following *Burrows v Matabele Gold Reefs and Estates Co Ltd* [1901] 2 Ch 23, held that it was not; but the House of Lords disagreed. Lord Davey gave the leading speech. He pointed out that in the *Ooregum* case the House of Lords had held that a company was not entitled to reduce its capital by allotting shares for less than their nominal value. But there was authority that suggested that the payment of brokerage commission did not infringe that rule. The section in question was intended to resolve the tension. As he explained at 479:

> "There were, therefore, two points for consideration: first, that shares could not be issued at a discount, i.e., subject to an agreement that the shareholder should pay less to the company than the nominal value of the share; and, secondly, the question whether the payment, out of capital moneys or by means of shares credited as fully or partly paid up, of what is called an underwriting commission was within the powers of a company."

82. Thus the first question related to the question whether the company had agreed to accept less than the nominal value of the share. That is covered by section 580. The second question was whether the payment of commission out of capital moneys (or its equivalent in the shape of share capital) was prohibited by the rule in *Ooregum*. The second question was thus only concerned with the application of capital money. It was not concerned with the application of distributable profits. The solution that Parliament adopted was, in Lord Davey's view, "a compromise". The first sub-section, he said "permits a limited application of the company's *capital* in payment of a commission." He then turned to consider the second sub-section, which corresponds to section 552. As to that, he said at 480:

> "The first words to be construed are, "apply any of its shares or capital money." I think that those words naturally mean apply its capital, either in the form of shares before issue, when they may be described as potential capital, or in the form of money derived from the issue of its shares. "In payment of any commission, discount, or allowance": I think this means payment by the company. The words "discount or allowance" seem to mean the same thing, namely, a rebate on what would justly be due from the subscriber on his shares. The advantage which the appellant will derive from the exercise of his option is certainly not a "discount or allowance," because he will have to pay 20s. in the pound for every share. Nor is it, in my opinion, a commission paid by the company, for the company will not part with any portion of its capital which is received by it intact, or indeed with any moneys belonging to it. "

83. Nor did he consider that the words "directly or indirectly" prevented a company from issuing shares at a price below market value. Thus:

> "… the benefit to the shareholder from being able to sell his shares at a premium is not obtained by him at the expense of the company's capital."

84. It seems to me to be clear that the section was (and section 552 is) also directed at the company's capital. In the present case, the payments made to Ms Stoneman and Mr Ralph were not made out of the company's capital. They were made out of the company's trading income (as they had to be in order to attract the intended tax treatment as a deductible expense for the purposes of the corporation tax computation). The company remained entitled to the unpaid capital on the issued shares as and when it was called. Accordingly, in my judgment they were not caught by the prohibition in section 552.

Result

85. Since I rejected both Mr Sykes' arguments on the impact of the Companies Act 2006, the question of mistake did not arise. It was for these reasons that I joined in the decision to dismiss the appeal.

Lord Justice Arnold:

86. I agree.

Lord Justice Edis:

87. I also agree.