Friday, December 7.

FIRST DIVISION.

[Lord Stormonth Darling, Ordinary.

D. & W. HENDERSON & COMPANY *v.* STEWART AND OTHERS.

Company—Liquidation under Supervision of Court—Compromise with Creditors—Sanction of Court—Reduction.

Where it is found in the liquidation of a company, while matters are still entire, that the sanction of the Court to a compromise between the liquidator and creditors has been obtained by concealment or non-disclosure of material facts, although with no fraudulent intention, such compromise cannot stand.

In the liquidation of a company under the supervision of the Court, the liquidator presented a note to the Lord Ordinary for approval of a compromise which he proposed to make with the directors, who were creditors of the company for the sum of £20,000, and claimed to hold a security of the value of £11,300. The directors did not appear in the proceedings under the note. The compromise proposed was that they should be held as secured to the amount of £10,000, and should be ranked as ordinary creditors for the balance of their claim. In his report accompanying the note the liquidator stated certain objections which might be urged against the validity and extent of the security claimed by the directors, but omitted all reference to the fact that the deeds conferring the security had been granted in February 1891 in respect of advances thereafter to be made to the company, whereas the debt of £20,000 had been incurred some years previously. The Lord Ordinary sanctioned the compromise.

In an action at the instance of unsecured creditors of the company, the Court (*aff.* judgment of Lord Stormonth Darling) *reduced* the interlocutor sanctioning the compromise, on the ground that it had been pronounced by the Lord Ordinary in ignorance of material facts, which it was the duty of the liquidator to place before the Court.

Opinions by Lord Kinnear and Lord Adam, that the unsecured creditors, or a committee of their number, should have had notice of the proposed compromise before it was sanctioned, but that the failure to give such notice was not a sufficient ground for setting aside the compromise.

In 1885 the directors of the State Steamship Company, Limited, for the accommodation of the company, discounted with the Clydesdale Bank a bill for £20,000 accepted by the company in their favour. This bill was renewed repeatedly by the bank, who were secured by mortgages over the company's steamers, until February 1889, when Mr James Reid Stewart, one of the directors, agreed himself to discount the bill at a lower rate than that charged by the bank. The bill was accordingly endorsed to Mr Stewart, and discounted by him. It was subsequently renewed on several occasions, the last renewal being on 3rd February 1891. The directors took no security for the bill from the company, believing that the mortgages over the steamers held by the bank continued good to them. Accordingly prior to and on 12th February 1891 the bill was unsecured.

On that date the directors (as the minute of meeting showed) resolved "to carry on the company's business as at present, pending a meeting of the shareholders and the adjustment of a scheme to be submitted to them, the necessary funds being obtained from the Clydesdale Bank on the guarantee of the directors, the directors to be secured by a bond of relief by the company, and the transfer of or a mortgage upon the reversion of the steamers." At the time the company were already indebted to the bank for various advances secured by mortgages on the steamers and by the personal guarantee of the directors.

A new account was accordingly opened with the bank upon the guarantee of the directors, who received as security bills of sale of the reversion of the steamers belonging to the company which had been previously mortgaged to the bank, dated and registered 17th February 1891.

Upon 4th March 1891 the company resolved to go into voluntary liquidation, and Mr Alexander Moore, C.A., Glasgow, was appointed liquidator, with a committee of advice composed of Mr Reid Stewart, two of the other directors, and three shareholders.

In April 1891 the steamers which had been mortgaged to the bank were sold for £65,500, out of which the bank received payment of their whole advances, and discharged their mortgages upon the vessels. After payment of the debt due to the bank and other preferable charges there remained a surplus of about £11,300. The directors maintained that they had a valid security over this surplus for the debt of £20,000 still due to them.

Upon 19th March 1892 the liquidation was continued under the supervision of the Court, and upon 24th March 1892 the liquidator presented a note to Lord Stormonth Darling, the Lord Ordinary, to whom the liquidation had been remitted, for approval of a compromise which he had provisionally made with the directors. He reported that they claimed to be secured creditors to the extent of £11,300; that he declined to accede to their views, on the ground (1) that the security of 17th February 1891 having been granted within sixty days of the commencement of the liquidation was invalid except in so far as it covered moneys advanced after

that date, and (2) because they had exceeded their power to pledge the property of the company; that the directors, on the other hand, maintained (1) that, the assets of the company having been sold before this question arose, the company could not be made notour bankrupt, and (2) that the limitation of their borrowing powers did not apply; that it appeared to be doubtful whether the company could be made notour bankrupt, but that, assuming the validity of the security, if his second contention were sound, the directors could only claim to be secured to the extent of £8118. The report did not contain any reference to the terms of the directors' resolution of 12th February 1891, or to the 164th section of the Companies Act 1862. The liquidator asked to be allowed to compromise the question by treating the directors as secured to the extent of £10,000, and as being entitled to an ordinary ranking for the balance of their claim. This compromise was sanctioned by interlocutor dated 25th March 1892. The directors did not appear in the proceedings under the note.

In December 1893 Messrs David and William Henderson & Company, shipbuilders, Partick, creditors of the company, brought an action of reduction against Mr James Reid Stewart and others, lately directors of said company, and against Mr Moore, the liquidator. By this action the pursuers sought to have the bills of sale of the steamers in favour of the directors and the interlocutor of 25th March 1892 sustaining the compromise reduced, and to have it declared that the directors were not secured creditors to any extent.

They narrated the circumstances set forth above, and stated that the bills of sale had been executed on 17th February 1891 solely to secure the directors for any subsequent advances they might make, and not to secure the then outstanding debt to them of £20,000. They averred that the sanction of the Court to the said compromise was obtained upon an insufficient statement of facts, and upon a suppression of material facts, which if fully disclosed would have led the Court to refuse its sanction. The securities in question were not only given in point of fact for the £20,000 bill, but were liable to be set aside as fraudulent preferences both at common law and under section 164 of the Companies Act 1862, which cuts down fraudulent preferences, and provides that "a resolution of winding-up the company shall in the case of a voluntary winding-up be deemed to correspond with the act of bankruptcy in the case of an individual trader." The only question between the liquidator and the directors was, whether the latter were entitled to hold the bills of sale from a hopelessly insolvent company under their management, and which was about to be wound up, as a valid security for the amount due to them on the £20,000 bill. But neither that question nor the essential facts bearing upon it (including the facts disclosed by the directors' minutes) were put before the Court in the said report.

The pursuers pleaded—"(1) The said compromise having been sanctioned, and the interlocutor sought to be reduced having been pronounced under essential error due to the suppression by the defenders, or one or other of them, of material facts as condescended on, decree of reduction ought to be pronounced as craved. (5) In respect that the said directors had not, at the date when the compromise was sanctioned, and never had any right to a preferential ranking, decree ought to be pronounced in terms of the conclusions of the summons with expenses."

The directors pleaded, *inter alia*—"(1) The pursuers' averments are irrelevant. (2) The liquidator having issued a deliverance ranking the defenders as preferable creditors for £10,000, and said deliverance not having been appealed against, is now final. (4) No material facts having been suppressed or concealed from the Lord Ordinary when the compromise in question was sanctioned, the interlocutor of the Lord Ordinary sanctioning said compromise cannot now be reduced. (5) *Separatim* — No material facts having been suppressed or concealed by the defenders, and the compromise in question having been, after full consideration, entered into by the liquidator, with the advice and consent of the shareholders' committee, and subsequently approved of and sanctioned by the Lord Ordinary, said compromise cannot now be reduced. (6) The compromise in question being a fair and reasonable one, and having been acted upon as stated, it cannot now be set aside. (7) The defenders having, at the date of the compromise in question, held valid securities over the property of the company, as above set forth, they were entitled to a preferential ranking for the whole sums for which they were creditors of the company."

The liquidator pleaded, *inter alia*—"(3) The compromise referred to being lawful and effected in *bona fide*, this defender should be assoilzied."

Upon 18th July 1894 the Lord Ordinary (STORMONTH DARLING) pronounced the following interlocutor:—"Finds that the defender James Reid Stewart and the other directors of the State Steamship Company, Limited, in whose favour and for whose behoof the bills of sale and endorsements or assignations sought to be reduced were granted, did not under these bills of sale and indorsements or assignations acquire or hold any security for the amount contained in the bill for £20,000 mentioned on record, and are not entitled to a preferential ranking for any portion of said sum of £20,000 in the liquidation of said company: Allows the defender Alexander Moore to satisfy the production as regards the interlocutor or decree eighth called for in the summons, and this having been done at the bar, holds the production satisfied so far as regards said interlocutor or decree, holds the record already closed as the record on the merits, and reduces said interlocutor or decree, and to that extent and effect decerns and declares in terms of the conclusions of the summons," &c.

"*Opinion.*—When a company is in voluntary liquidation, a compromise with creditors requires the sanction of an extraordinary resolution of the company, but where the liquidation is under the supervision (as in the case of an official liquidation) a compromise can only be made with the sanction of the Court. The Court is thus a necessary party to the arrangement, and it is settled by the case of *Clarke* v. *Hinde, Milne, & Company*, 12 R. 347, that if the sanction of the Court has been granted in ignorance of material facts the compromise cannot stand. I should myself be disposed to add to that statement of the law, that the same results ought to follow where, without any actual mistatement or suppression of facts, the question which is the subject of compromise, has not been fairly or fully stated to the Court.

"This action is brought by certain creditors in the liquidation of the State Steamship Company, Limited, against the directors and liquidator of the company, and it seeks to reduce a compromise between the directors and the liquidator, which I sanctioned as Lord Ordinary officiating on the Bills, by interlocutor dated 25th March 1892, six days after the supervision order had been pronounced.

"The circumstances which led to the compromise were these. Prior to 12th February 1891 the company was due to the directors £20,000, being the amount of a bill (the last of a series) accepted by the company to all the directors, and by them endorsed to the defender Mr Reid Stewart, one of their number. The earlier bills had been discounted by the company's bankers under a cash-credit, which was secured by mortgages over the company's steamers, but the later bills were discounted by Mr Stewart personally, and notwithstanding a somewhat halting allegation in Ans. 3 and 4 for the liquidator, and Stat. 4 for the directors, it cannot be seriously maintained that in Mr Stewart's hands the bills were covered by the security held by the bank. The debt of £20,000 was therefore an unsecured debt as at 12th February 1891. On that date the directors had before them an unfavourable report by a firm of accountants on the financial position of the company, and they considered what steps should be taken in view of possible liquidation. They were of opinion that it was desirable to carry on the company's business pending a meeting of shareholders, and as this could only be done by raising money, it was resolved to obtain the necessary funds from the bank on the guarantee of the directors, who were to be secured by a bond of relief by the company, and the transfer of, or a mortgage upon, the reversion of the steamers. In pursuance of this arrangement bills of sale in favour of the directors of the six vessels belonging to the company were laid before the next meeting on 17th February, and the security was ultimately completed by indorsation of the policies of insurance on the vessels. On 24th February the directors issued a circular to the shareholders in which they stated that, unless a sum of from £80,000 to £90,000 of additional capital could be raised, there was no alternative but liquidation; and at a meeting of shareholders held on 4th March it was resolved that the company should be wound up voluntarily, and Mr Moore was appointed liquidator.

"In April 1891 the liquidator, with the consent of the bank and the directors, sold the steamers of the company to Messrs Allan of the Allan Line for £70,000, out of which the bank received payment of their whole advances, and discharged their mortgages upon the vessels. The directors were thus relieved of the responsibility which they had incurred to the bank on 12th February, and the only claim remaining to them was the old debt of £20,000 to which I have referred.

"Now, when the liquidator came to deal with this claim there were two, and I think only two, questions with regard to it, viz., (first) whether in point of fact the bills of sale were granted for anything but an immediate advance of money; and (second) if they were, whether the security was not an undue or fraudulent preference within the meaning of section 164 of the Companies Act of 1862. The liquidator had some negotiations with the directors, and on 30th March 1891 obtained from them a letter, under which they agreed that in any question with them the Companies Act 1886 should be held to apply, and that their securities should be dealt with as if the liquidation was being carried on under the supervision of the Court, and as if a supervision order had been pronounced on the date of the letter. So far the liquidator was proceeding on right lines. When, a year later, the actual supervision order was pronounced, and he applied to the Court for sanction of the compromise which he had provisionally made with the directors, he had either lost sight of the real questions at issue, or he contrived most effectually to obscure them in the written report which he presented along with his application.

"On the first of the questions which I have mentioned the report is altogether silent. It contains no reference to the minutes of the directors, and it does not call attention to the fact that as shown thereby the bills of sale were granted simply and solely to secure the directors against their guarantee to the bank. It is now said that, even though that were the case, they were entitled to retain the security until the prior debt was paid. I do not think they were. The case of *Hamilton* v. *Western Bank*, 19 D. 152, cited by the defenders, is no authority for that proposition, because the bank were there held entitled to retain their security not for prior, but for subsequent advances, which were held to have been made on the faith of the security. It would be a strange result if directors, being unsecured creditors for a past debt, could obtain security for it without any stipulation to that effect, and simply by the expedient of undertaking a fresh liability, and obtaining a security in respect of that. Neither does the analogy of pledge to which the defenders appealed afford any support to their contention, for the subject of the

pledge must undoubtedly be restored when the debt for which it was granted has been paid. The bills of sale are no doubt absolute in their terms, but their effect is controlled by the acknowledgment of the directors in their own minutes that they were granted for a particular purpose. It seems to me therefore that the omission to disclose the terms of the minutes was in itself a fatal flaw in the liquidator's report.

"On the second question, the report is also, I think, most misleading. It makes no reference to the 164th section of the Companies Act, and it expends a great deal of misplaced ingenuity in arguing a question about the limit imposed by the articles of association on the directors' power to pledge the property of the company. It deals with the figures in such a way as to suggest that the true question was between the directors' view on the one hand, that they were secured to the extent of £11,300, and unsecured to the extent of £8700, and the liquidator's view, on the other, that they were secured to the extent of £8118, and unsecured to the extent of £11,882. If that had been the true question, a compromise by which they were to be held as secured to the extent of £10,000, and unsecured to the extent of £10,000 might have been fair enough. There is also a great deal in the report about the difficulty of making the company notour bankrupt, but no point is made of the fact that the bills of sale (if capable of being held as a security for the prior debt) were granted in contemplation of a winding-up, and within sixty days of a resolution to wind up. Now, the resolution to wind up in the case of a voluntary liquidation is by the 164th section made equivalent to the bankruptcy of an individual trader, and if an individual trader had granted such a security as this (assuming it to apply to the prior debt) within sixty days of his sequestration undoubtedly it would have been illegal.

"I have come to the conclusion therefore that the compromise and my own interlocutor approving of it ought to be rescinded. It might have been impossible to do so if matters had not been entire, but just as in *Clark's* case the assets are still undivided, and rescission will not in any way prejudice the right of the directors to an ordinary ranking. I say that neither the facts nor the arguments were fully before me when I sanctioned the compromise, and that if they had been I would have refused to sanction it. I regret now that I did not order intimation of the liquidator's note to the creditors, or convene a meeting of creditors for consideration of the compromise. But I do not see that except in that way I could have acted otherwise than I did on the materials before me. I demur altogether to the notion that it is the duty of a judge in a liquidation to act as a detective. He has not the means of making independent investigations, and he must of necessity rely not only on the accuracy and sufficiency of the statements put before him by the liquidator, but on the exercise of the liquidator's discretion being probably sound. In the vast majority of cases the compromise proposed is the expedient course, and of the many proposals for compromise which have come before me within the last four years I do not remember more than one in which I refused my sanction. As it happens, the case occurred in this very liquidation, but I refused my sanction not on the ground that the claim was necessarily bad, but that in the circumstances the claimants ought to be put to prove it.

"If the parties had not joined issue on the question whether the security was good it might have been proper to deal only with the interlocutor sanctioning the compromise, leaving it open to the directors still to make out their claim to a preference for the whole £20,000 if they could. But the question of their right to a preference has been fully argued with all the parties in the field, and therefore I think the best course is to decide not merely that the sanction of the Court was obtained without full disclosure of the facts and arguments, but that the directors are not entitled to more than an ordinary ranking.

"The debate was conducted by the parties (and I took the case to avizandum) on the footing that it was ripe for judgment on the merits. It now appears that when the debate took place production had not been satisfied, but both parties were anxious to get over this formal difficulty, and accordingly they suggested a form of interlocutor to which I have given effect."

The directors reclaimed, and argued—(1) The action was irrelevant. It was not said from the beginning to the end of the record that the directors had done anything they should not have done, or had abstained from doing anything they should have done. The whole case was based upon the alleged fault of the liquidator in omitting to state all the circumstances he might have set forth, and in failing to bring forward certain pleas-in-law. That was no reason for setting aside the compromise with the directors. To do that it was necessary to show fraud on their part in bringing about or obtaining the sanction of the Court. They and the liquidator were at arm's length in arranging for a settlement. They were not entitled to know what passed between the liquidator and the Court. If they were to know the weakness of the liquidator's position they might object to the compromise. By compromising they took their chance, and such a compromise was protected. The rights of the other creditors were protected by the liquidator—See Buckley's notes on section 159 of the Companies Act 1862, and the English cases of *re Home Counties Life Assurance Association, ex parte Garstin*, 1862, 6 L.T. 374; *re Leeds Banking Company ex parte Clarke*, 1866, 14 L.T. 789; *in re Central Darjeeling Tea Company*, Weekly Notes, 1866, p. 361. The only Scotch case where a compromise sanctioned by the Court had been set aside was *Clark, &c.* v. *Hinde, Milne, & Company*, Dec. 17, 1884, 12 R. 347, but in that case there had been active interference on the part of the creditor. (2) Assuming the action not to be irrelevant, and that the

Court might interfere, enough had been put before the Court when the sanction was asked to make such a course unwarranted. It was not suggested that the directors held securities other than the bills of sale. The sole question was as to their rights under them. They claimed to be secured thereby with respect to their debt of £20,000, the liquidator saw several legal difficulties which he could not solve without the expense of litigation, so he compromised the case. One legal difficulty was as to making a company notour bankrupt so as to cut down preferences. That difficulty he had stated to the Court. His failure to state other difficulties would not invalidate the compromise, the great object of which was to avoid all such difficulties. It was argued on the other side that it was certain the directors held no security for prior claims. But the title to the bills of sale was *ex facie* absolute, and therefore a complete security, which the creditors were only bound to reconvey after all their claims of whatever date had been satisfied—*Robertson* v. *Duff*, 1840, 2 D. 279; *Hamilton* v. *Western Bank*, 1856, 19 D. 152; *National Bank* v. *Forbes*, 1858, 21 D. 79. The Court was not bound to institute further inquiries. Its function was to enable the liquidator to carry out compromises upon being satisfied that the liquidator had fairly and fully considered the matter. The application of the 164th section of the Act of 1862 was not free from difficulty—*National Bank* v. *Macqueen*, July 13, 1881, 18 S.L.R. 683; *Benhar Coal Company* v. *Turnbull*, February 6, 1883, 10 R. 558.

Argued for the liquidator—He had endeavoured to give the Court all the information then in his knowledge.

Argued for the respondents—The Lord Ordinary's judgment was right. He explained how he had been misled, and in face of that explanation it was impossible the sanction given under misapprehension could stand. His duty was not merely to confirm the liquidator's opinion; he had to exercise a judicial function after being informed of all the facts—*Northumberland and Durham District Banking Company*, 1860, 1 Drewry & Small, 273. The liquidator had failed to set forth material facts, particularly the terms of the resolution of 12th February 1891; that was sufficient to set aside the compromise. It was not necessary to show essential error or fraud. The minute of 12th February 1891 showed that the security to be given was for particular advances thereafter to be made. The transaction was also bad under section 164 of the Companies Act—*Gaslight Improvement Company* v. *Terrell*, 1870, L.R., 10 Eq. 168. "Act of bankruptcy" as applied to Scotland plainly meant the same as notour bankruptcy.

At advising—

LORD KINNEAR—The pursuers are creditors of the State Steamship Company in liquidation, and they bring this action for reduction of certain bills of sale which the defenders, who were directors of the company, claimed to hold in security of certain debts due to them by the company, for reduction of an interlocutor pronounced by Lord Stormonth Darling on the 25th March 1892 sanctioning a compromise with the defenders, and authorising the liquidator to allow the securities in question to stand as valid securities in favour of the defenders to the extent of £10,000, and for declarator that the defenders are not entitled to have a preferential ranking to any extent in the liquidation, and that the preference which has been allowed is null and void.

The parties are not entirely at one as to the financial position of the company when it resolved to wind up. But it is admitted that it had sustained heavy losses in the autumn and winter of 1890 and in the beginning of 1891, and that on the 4th of March 1891 it resolved to wind up voluntarily on the ground that "on account of its liabilities it could not continue its business." At the same meeting the defender, Mr Moore, was appointed liquidator, with power to carry on the business for such time as he might think proper, and a Committee of Advice was appointed to consult with him, consisting of six shareholders, three of whom had been directors, and are now defenders in this action. On the 10th of March 1892 an order was pronounced continuing the liquidation under the supervision of the Court, and confirming the appointment of the liquidator and the Committee of Advice, and on the 24th of March 1892 the liquidator presented a note to Lord Stormonth Darling for approval of the compromise in question.

The claim which forms the subject of the compromise arises out of a transaction which is recorded in a minute of meeting of the directors on the 12th February 1891, a little less than a month before the resolution to wind up. At this meeting the directors resolved "to carry on the company's business as at present pending a meeting of the shareholders, and the adjustment of a scheme to be submitted to them, the necessary funds being obtained from the bank on the guarantee of the directors, the directors to be secured by a bond of relief by the company, and the transfer of or a mortgage upon the reversion of the steamers." This arrangement was carried out, and on the 17th of February a bond of relief by the company in favour of Messrs James Reid Stewart, Thomas Reid, Robert Dick, Thomas M. Ferguson, Peter Hutchison, and James Wilson, was laid before the meeting; and also bills of sale by the company in favour of the same gentlemen, of the s.s. "State of Nevada," "State of Indiana," "State of Georgia," "State of Nebraska," "State of Pennsylvania" and "State of Alabama," which were duly signed and sealed.

It appears that at the date when this arrangement was made the company was already indebted to the Clydesdale Bank for very considerable sums, which the bank had advanced on the security of mortgages over the six steamships, and on the guarantee

of the directors. In consequence of the arrangement of 12th February additional advances were made upon the same terms, and there can be no question that all of these advances were validly secured, the advances on the first account by the mortgages to the bank, and the advances on the second by the bills of sale in favour of the directors. But there was at the same time a separate debt of £20,000 due to the directors for which they held no security whatever. In 1885 they had discounted with the Clydesdale Bank an acceptance to that amount by the company in their favour as individuals, and the advance so obtained was continued by repeated renewals of the bill until February 1889. At that date it was arranged that instead of discounting a renewal bill with the bank as before, the bill should be discounted at a lower rate by Mr James Reid Stewart, one of the defenders, and this was accordingly done. There can be no doubt that the bill was discounted, and that the defenders became liable for the amount on the understanding that they should be relieved of responsibility by the company. But they took no security for that relief over the property of the company or any part of it, and on the 12th February, when they took bills of sale for the new liability they were then undertaking, their claim under the bill for £20,000 was still unsecured. In the course of the liquidation the steamships were sold by the liquidator with concurrence of the bank and the directors. It is not disputed that the debts due to the bank are a first charge upon the price. But a surplus remains after these have been satisfied, and the directors maintain that they have a security over the proceeds of sale for relief of the £20,000 bill also, and consequently that they are entitled to a preferable ranking for that sum.

No claim was lodged by the directors in the liquidation until after the Lord Ordinary had pronounced the interlocutor of 26th March 1892, and we have accordingly no record of the grounds on which the claim for preference was maintained by them or resisted by the liquidators, excepting the liquidator's report to the Lord Ordinary. But the defenders aver on record that they rested their claim on two grounds, first, that they were entitled to retain the steamers or the proceeds thereof under the mortgages held by the bank; and secondly, that they were so entitled under the absolute bills of sale which had been granted in their favour on the 17th of February. The first ground appears to have been founded on their belief that the £20,000 bill was covered by the securities held by the bank in the same manner as if it had been discounted by the bank instead of by Mr Stewart. I do not understand it to be now maintained that this is in law a tenable ground of preference, and it is certain that it was not brought before the Lord Ordinary as a reason for sustaining the compromise. The second ground is rested on the doctrine of law that a disponee or assignee possessing under a title *ex facie* absolute may, when called upon to denude in favour of the true owner, retain the subject until all the obligations incumbent on the owner to him shall be fulfilled, whether they have been incurred before or after the date of the conveyance in his favour. To this contention there are two answers, first, that if the absolute title is shown by back-bond or other competent evidence to have been given in security of a particular debt specially contemplated by the parties, such security cannot be extended by the principle of retention to other debts previously due, and known to the parties, and that the minute of 12th February shows that the bills of sale then authorised were intended to form a security for the new liability then undertaken, and not for any prior debt whatever; and second, that if the bills of sale were in fact intended as a security for prior debts, the transaction is challengeable both at common law and under the statutes, as an undue preference which the directors attempted to give to themselves to the prejudice of prior creditors when the company was on the eve of liquidation.

I assume for the present that both of these points might reasonably be considered doubtful so as to justify the liquidator in compromising the claim, and if the validity of the compromise depended solely on the contract between the liquidator and the defenders, there seems to be no reason why it should not receive effect. No material fact that was known to the defenders was concealed from the liquidator, and he had the same means as they had for forming a sound judgment as to the expediency of the arrangement.

The question is, whether the agreement has been validly sanctioned by the Lord Ordinary.

An objection is taken to the procedure, inasmuch as no notice was given to the creditors either of the proposal to compromise, or of the application to the Lord Ordinary. I agree with an observation of the Lord Ordinary that it would have been well that such notice had been given. The creditors were the only persons interested in the question, and it appears to me not only that they or a committee of their number if they were too numerous to be consulted individually, should have had notice of the proposed agreement, but that their decision as to the acceptance of a compromise might have been conclusive unless they were so far divided in opinion as to make it necessary for the liquidator to intervene. There may be cases in which the separate interest of a particular class of creditors must be subordinate to the general interest of the liquidation. But the only question to be considered in the present case was whether the claim of the directors for a preference should be resisted in the interest of the unsecured creditors. That is a question which they might well have been allowed to decide for themselves, and whether their decision would have been final or not, it appears to me that a compromise ought not to have been forced upon them without giving them an opportunity of objecting. But this is not an objection that in itself would

be fatal to the validity of an agreement which had been sanctioned by the Court. The unsecured creditors are only indirectly affected by the compromise with the directors. They were not parties to it, and accordingly I do not understand it to be disputed that, if the compromise had been duly sanctioned, the creditors must submit to the consequent diminution of the funds available for payment of their debts. The objection is no more than a criticism of the procedure. But the pursuers are at least entitled to say that, if the liquidator did not think fit to inform them of his proceedings, it was all the more incumbent on him to exercise vigilance on their behalf, and to take care that the grounds on which the directors' claim might be resisted were fully and accurately stated to the Lord Ordinary, and they allege that he failed in this duty in two respects.

It is said that the Lord Ordinary was misled by the concealment or non-disclosure of the fact on which the claim for a preference depends, and also by the liquidator's failure to bring under his notice the terms of the 164th section of the Companies Act 1862.

The last point does not appear to me to be material.

The Court is familiar with the statute under which it conducts or supervises liquidations; and the Lord Ordinary must be supposed to have considered for himself the clauses bearing on a question which had been fairly stated to him. But if it were otherwise, the failure of the liquidator to raise the proper argument on a point of law would appear to me to be no ground for disturbing a compromise. There would be no room for transaction if the legal rights of parties had been completely ascertained, and every compromise therefore assumes that points of law may have been overlooked or misunderstood.

But the other objection is much more formidable. The directors' right to a preference depends upon the meaning and legal effect of the minute of 12th February 1891, and that minute was not laid before the Lord Ordinary. It is said that it was for his Lordship to consider whether he had sufficient materials before him to determine his discretion, and that might have been a good answer if the question had been fairly raised. But there is nothing in the liquidator's report to suggest that any question as to the existence of the alleged security had been or could be raised. The Lord Ordinary read the report as meaning that in fact the directors held an undoubted security for the debt in question, which was impeachable only because it had been granted within sixty days of the liquidation, and on no other ground, and that is the natural construction of the report. It is possible to infer from the liquidator's statement that the security was constituted by bills of sale *ex facie* absolute, and it may be also that these bills of sale had been granted in relief of the obligation undertaken on the 19th of February. But there is nothing to suggest that the terms of the arrangement were expressed in any writing other than the bills of sale themselves, or that they implied, or could be alleged to imply a limitation of the security. I think therefore that the question on which the Lord Ordinary was called upon to exercise a judicial discretion was not fairly stated. He was asked to consider whether a claim founded on a security granted within sixty days of the liquidation should be compromised or resisted. He was not informed that the application of the security to the debt was in any way open to question, and the facts which would have shown that such a question might be raised were not brought before him. His Lordship therefore sanctioned the compromise in ignorance of material facts.

Now, if the misapprehension of the Lord Ordinary had been caused by the statements of the defenders, I do not understand it to be maintained that they could have held a compromise sanctioned in error induced by themselves. But it is said that they are adverse parties, dealing at arm's length with the liquidator, and that the validity of their contract with him must be determined on precisely the same principles as if he were contracting on his own account, or for others whom he had full authority to bind; that the sanction of the Court is required to supplement the defective authority of the liquidator, but that creditors with whom the liquidator contracts have no concern with the grounds on which it is given or withheld, and no duty in the matter except to deal fairly with the liquidator himself. They are not responsible for the statements by which the Lord Ordinary may have been influenced, and even if his sanction had been procured by false and fraudulent representations, the contract so sanctioned could not be set aside in a question with them unless they had themselves been parties to the fraud.

This appears to me to proceed upon a misconception of the relative position of the parties and the Court. So far as the liquidator is concerned, it may be that a creditor contracts with him at arm's length. The proceedings are not analogous to proceedings in bankruptcy, and the liquidator has certainly power to settle claims by agreement. But when the sanction of the Court is required the position is entirely altered. The Judge is not a party to the agreement. Nor is he the mere adviser of the liquidator. His function is always and necessarily judicial. The conditions on which the Court must give or withhold its sanction have been stated by Lord Romilly in the case of the *Northumberland and District Bank*, 1 Drewry & Small, 273. The Court is asked "to exercise a judicial discretion, which is in effect a judicial judgment, not on a point of law, but on a point of expediency and propriety." The Judge therefore cannot authorise or direct the liquidator to make a compromise without exercising his judgment on the propriety and expediency of that compromise, and that cannot be done without knowledge of all the facts and circumstances by which his judgment

should be determined. I think it follows that parties to a compromise which is submitted for sanction are both of them parties before the Court, and it is the duty of both to state the facts by which the discretion of the Court is to be determined fully and correctly, or to see that they are fully and correctly stated. I cannot assent to the view taken by the Lord Ordinary, that the Court is entitled to rely on the liquidator's discretion. His opinion is entitled to weight, because he is more intimately acquainted than the Court can be with the concerns of the company. But the Court must exercise an independent judgment, and cannot delegate its authority to the liquidator.

It is said that the liquidator alone has an opportunity of being heard. But that is an entire misconception. In my experience the rule has been that when an agreement is submitted for the sanction of a judge, both parties have been called upon to attend in Court or in chambers to explain and support it. If the Lord Ordinary thought this unnecessary in the present case, the defenders were nevertheless entitled, if they had desired, to appear and be heard in support of the agreement, and, if they did not think fit to exercise that right, they had an earlier opportunity of stating their claim in such a manner as to bring it before the Lord Ordinary on their own responsibility. The ordinary course is that a creditor in a liquidation should lodge his claim with the liquidator, setting forth specifically the grounds in fact and law on which it is based, and if he discharges that duty for himself so that his claim may be laid before the Court in his own language, it may be that he is not responsible for anything the liquidator may add without his knowledge. But if instead of following the regular course of procedure he chooses to make a verbal bargain with the liquidator, and leaves the liquidator to state his claim for him to the Court, he must be responsible for the omissions or false statements of the liquidator as if they had been made by himself. He has in effect made the liquidator his agent to state his case to the Court.

But there is an additional reason for holding that the defenders must accept the liquidator's statement as if it had been made by themselves. Three of the defenders were members of the Shareholders' Committee of Advice, and it is averred on record that the terms of compromise were submitted to and approved by that committee, and further, it is not said that they or that the defenders who were not members of the committee were ignorant of the terms of the report, and I think such an averment is necessary to support the case now made for them in so far as it rests on a denial of their responsibility for the liquidator's statements.

It is right to say that I see no reason for supposing that either the liquidator or the defenders intended to conceal anything from the Lord Ordinary which they themselves thought material. I should infer from the report and the statements on record that the defenders believed they held a valid security for the £20,000 bill, but without having any clear conception of the manner in which it had been constituted. At all events, I do not suppose they had adverted to the importance of the minute of 12th February. But the result is, that, however honestly, they have laid before the Lord Ordinary through the liquidator an imperfect statement of their case, with the effect of misleading his Lordship as to the true question which it was proposed to settle. The only question on which his Lordship was moved to authorise a compromise was, whether a security otherwise valid had been cut down by a supervening liquidation. He was not informed that there was a prior question whether the defenders as creditors held any security whatever for the only debt which still remains due. It appears to me therefore that the Lord Ordinary gave no real sanction to the compromise. As the funds are still in the hands of the liquidator, who holds them as trustee for equal distribution among the creditors, it is not too late to set aside the interlocutor and the agreement following upon it, so as to allow the questions in dispute to be determined on their merits.

I do not think *Clark* v. *Hinde, Milne, & Company*, to which the Lord Ordinary refers, is directly in point. The question was not whether the compromise which the Court had sanctioned should be reduced as between the preferred creditor and the general body of creditors, but whether particular creditors who had acquired the same security by the diligence of poinding as the preferred creditor should be allowed, notwithstanding the terms of the compromise with him, to participate with him in the proceeds of poinded goods. Their claims had not been brought before the Court when the compromise was sanctioned, and their existence was designedly concealed by the preferred creditor. The case therefore appears to be distinguishable. But, irrespective of previous decisions, I think we must hold that where it is found, while matters are still entire, that the sanction of the Court has been obtained by concealment or non-disclosure, although with no fraudulent intention, of material facts, a compromise so sanctioned ought not to stand.

LORD ADAM—I agree with Lord Kinnear. What has struck me throughout these proceedings is that the question which was the subject of compromise or attempted compromise was entirely a question, so far as I can see, between the secured and the unsecured creditors, and it was a very important question, because the result of the compromise, if it be sustained, is this, that out of a balance stated to amount to about £12,000, no less than £10,000 will be carried away by the secured creditors, leaving them still to claim for another £10,000 on the balance of £2000. Now, that was a very serious question for the unsecured creditors, and yet, so far as I can see, throughout the whole of these proceedings it never seems to have occurred

to the liquidator to consult these creditors, whose interests he had taken in hand and proposed to compromise, as to whether they wished or did not wish such a compromise. So far as I can see, there would have been no prejudice to the company in this case to have allowed the creditors, both secured and unsecured, to have fought out their quarrel to the end; and if the liquidator had consulted the unsecured creditors he would not only have ascertained their wishes, but very probably he would have ascertained that which he never seems to have appreciated, viz., what the true issue between the parties was, and the grounds on which the pursuers maintained and now maintain that no security was ever created by the bills of sale of February 1891 in favour of the defenders in respect of the debt for which they now claim. But throughout these proceedings, so far as I can see, there is not a trace that, although the liquidator charged himself with the interests of these unsecured creditors, he ever approached them in one way or other to let them know what he proposed to do with reference to this matter. I agree with Lord Kinnear that there may be cases in which, there being a division of opinion among the unsecured creditors as to whether they should compromise or not, it would be quite right for the liquidator to compromise, and that the company through the liquidator would have an interest in the compromise being carried out. But I do not see that in this case the company was concerned very much in the matter at all. I also agree with Lord Kinnear that that alone would not justify the reduction of a compromise, but I think it would place a heavy *onus* on the liquidator who had charged himself with the interests of third parties, to see that their interests were in no way prejudiced by what he did. It may not have been incompetent in the liquidator to have settled the claim, but I cannot say that his proceedings in the matter were very judicious. I also agree with Lord Kinnear that the Court in sanctioning a compromise under these Acts is exercising always a judicial discretion. It was very forcibly argued to us by Mr Asher that in obtaining the sanction of the Court the parties were acting as parties at arm's length, that the liquidator had ample power to compromise, that it was his duty alone to obtain the sanction of the Court, and that it did not affect the directors what representation of the case was made to the Court, and on what representation the sanction of the Court was obtained. I do not at all agree with that proposition. I think the duty of the Court in this matter is, as set out by Lord Romilly, as quoted by Lord Kinnear, to exercise a judicial discretion, and that all material facts must be before the Court before they can possibly give their sanction in such a matter, and that if material facts are withheld from the Court any sanction obtained in such circumstances cannot stand. I think with Lord Kinnear that it is as much the duty of the one party as the other to see that all the facts are before the Court when obtaining such sanction. Now, it appears to me to be quite clear that in this case that was not done. We now know that the most material fact at issue between the secured and the unsecured creditors was this, whether or not there had ever been a security created in favour of those claiming to be secured by the bills of sale granted in February 1891. That is the great question at issue, and on that question the Lord Ordinary's opinion on the merits is that there was none. I do not think it necessary for the decision of the question as to whether the sanction should stand or not, to decide whether the Lord Ordinary is right on that matter, because, whether he is right or wrong, it certainly is shown that there was a most material question at issue between the parties, whether such a security ever was created or ever existed, and that was a most material fact to be before the Lord Ordinary in deciding whether there should be a compromise or what the terms of the compromise should he. But that question was never brought before the Lord Ordinary's consideration. He was asked "to approve of the proposed compromise, and to authorise the liquidator to allow the security created by the bills of sale in favour of" so-and-so, dated 17th February 1891, to stand to the extent of £10,000. That was the way in which it was put to the Lord Ordinary, as if it was a security which apparently no one disputed, and as if the question for his consideration was whether he would sanction the proposal that that security should stand as a preferable security to the extent of £10,000. The report of the liquidator deals with the claims on the estate, and the claim of the directors is dealt with, and the liquidator says—"The liquidator declined to accede to this view upon the ground (1) that the security of 17th February 1891 having been granted within sixty days of the commencement of the liquidation was invalid, except in so far as it covered moneys advanced after that date; and (2) because the power of the directors to pledge the property of the company for moneys borrowed was limited by the articles of association to £50,000." That is the matter which the Lord Ordinary was asked to consider, and he was never informed that there was any doubt or question as to it being a good security. This being so, the next question is whether that is a sufficient ground for setting aside the sanction granted by the Lord Ordinary. It is said that, though the question is not specifically set forth, there are sufficient facts stated in the report to enable the Lord Ordinary to find out for himself that possibly the security might not be a good one. Perhaps if the mind of the Lord Ordinary had not, if I may so say, been diverted from the real question between the parties; if he had been asked to consider the facts so far as stated, and to say whether it was or was not certain that the creditors had a security created by the bills of sale, it

might have been that some doubts would have been raised in the Lord Ordinary's mind as to whether or not they had such a security. But he was told that nobody questioned that there was a security so created, and apart from that the material facts were not laid before the Lord Ordinary. As Lord Kinnear has pointed out, the whole material facts as to whether this constituted a good security or not were contained in the minutes, which show that there was a special agreement as to the terms in which the bills of sale were granted, which would have been a most material fact in the question whether or not they did create a valid security. But these were never brought under the consideration of the Lord Ordinary. Upon the whole matter, I have no hesitation in agreeing with Lord Kinnear that the sanction obtained from the Lord Ordinary in these circumstances cannot be sustained, and although great weight might be given to the views or the recommendations of the liquidator, that cannot relieve the Lord Ordinary or the Court from considering the whole facts in order to enable them to come to a proper decision.

LORD M'LAREN—I have had from the beginning a strong impression that we could not sanction a compromise to which the Lord Ordinary's approval was necessary, when we were informed by the judge that he would not have given that approval if the facts of the case had been fully before him.

Without recapitulating the facts which have been stated by Lord Kinnear, I may begin by observing that the facts disclosed three objections to the preference claimed by the directors of this steamship company over the proceeds of the sale of the ships. Two of these objections were brought under the notice of the Lord Ordinary in the official report which the liquidator presented along with his note asking the judge's approval of the compromise into which he had provisionally entered. In this report it is stated that the directors held a transfer of the ships which were the property of the insolvent firm in security of advances, but that, the company having gone into liquidation within sixty days after the date of the transfer, he, the liquidator, had put forward the objection that the security was reducible under the statute of 1696. At the same time, he explained that there were technical difficulties as to making the company notour bankrupt within the statutory period, and this difficulty made it expedient that the question should be treated as a subject of compromise. It is objected to this statement of the question that the liquidator did not call the attention of the Lord Ordinary to the provisions of the 164th section of the Companies Act, which makes the liquidation itself in certain circumstances equivalent to an act of bankruptcy. I may say that I do not entertain any doubt that the 164th section is applicable to Scotland, and is effective to cut down preferences to the same extent to which these would be cut down by any other act or state of circumstances which the law has declared to be equivalent to notour bankruptcy. There are not two kinds of bankruptcy known to our law, and the absence of the qualifying word "notour" in an enactment which applies to the United Kingdom does not in my mind raise any difficulty as to the meaning and effect of the statutory provision.

But then this is a liquidation under the Companies Act, and while it may be very proper that the liquidator should invite the attention of the judge to these provisions of the Act which were material to the point under consideration, I think it must be held that the whole Act was before the judge; and the omission on the part of the liquidator to deal with a question of company law, while it may suggest a doubt whether this compromise was properly considered, cannot have the effect of nullifying the compromise after it has received the necessary judicial approval.

On the second objection to the preference claimed by the directors, that they had exceeded their borrowing powers, I shall say nothing, because it is fully discussed in the liquidator's report, and it is not said that there was any omission in regard to the statement of this part of the case.

There remains for consideration the effect to be attributed to the third objection to the preference—the most important of the three—which is, that as a matter of fact the directors held no security for a liability amounting to £20,000 which they had undertaken on behalf of the company by becoming parties to a bill discounted by one of their number.

The case of the pursuers is that no notice whatever is taken of this objection, or the facts on which it is founded, in the report submitted to the Lord Ordinary. I am free to say that, after an attentive study of the report, I cannot find in it any reference to the circumstance that the security held by the directors was not in effect a security covering the liability on the £20,000 bill. The omission is the more remarkable—indeed inexplicable—because the report plainly shows that it was this very sum of £20,000 which the liquidator proposed to compromise on equal terms by sustaining the directors' preference to the extent of £10,000.

The minutes of the board of directors disclose that the security which they hold was acquired after this liability had been incurred, and that the ships were taken by them in pledge for a different purpose altogether, viz., in relief of their obligations to their bankers under credits which they had obtained for the company on their personal responsibility. The words of the minute are—[*Its terms are given above*]. Now, it is quite true that persons who sustain a fiduciary character have a general right of retention over estate of the beneficiary coming into their hands in the ordinary course of business; and if, for ex-

ample, these ships had been reconveyed to the directors by a mortgagee whose advances were being paid off, it may very well be that the directors might have claimed in bankruptcy to retain the ships against past as well as subsequent advances. But, in the actual case, the security was the act of the directors themselves, and in such circumstances, and in view of the minute, equivalent to a declaration of trust, limiting the effect of the proposed transfer to a security for specific debts, I fail to see that the directors could have any general security or right of retention for past advances. The subsequent minute, stating that the individual directors were to hold the ships in security of advances made or to be made, cannot in my opinion affect the question, because the directors could not in my view extend the operation of the security so as to cover past advances.

But the immediate question is not whether the directors could have made good a claim to retain for past advances, but whether the non-disclosure of the objection to the security amounts to the suppression of a material fact which deprives the Lord Ordinary's assent to the compromise of the authority otherwise due to it. I think that the report when fairly read amounts to the statement that the directors held the ships in security of advances generally, including the £20,000 liability, and this statement is not consistent with the terms of the minute defining the purpose of the transfer. The Lord Ordinary states in his judgment that, if the terms of the transaction had been before him, he would not have given his sanction to the compromise, and it is palpable that, with the knowledge which we now have of the facts of the case, the compromise was not a fair one. That being so, I think that a judicial compromise which is affected by error *in essentialibus* may be annulled under the same conditions as any other agreement. The creditors, whose interests are affected, are not responsible for the erroneous statement, and I think that the directors must be taken to be responsible for it, because it was in setting forth their case that the error was committed; it was their representation that they held the ships in security of the liability in dispute.

I have had some doubts as to whether we could do more in this case than to reduce the Lord Ordinary's decree. But we were invited by counsel on both sides to adjudicate on the validity of the directors' claim, and I think we are now in a position to do so, provided it is made clear that neither of the parties desires a proof.

LORD PRESIDENT—I agree with the opinion of Lord Kinnear, and, with reference to the point last adverted to by Lord M'Laren, I understand the prevalent opinion to be that the safer course would be to stop short of reducing the compromise and to restrict our decree of reduction to the decree of the Court sanctioning the compromise. That being your Lordships' view, probably the most convenient course would be to recal the Lord Ordinary's interlocutor, which does a great variety of things, and to of new repel the defences as preliminary, reserving them on the merits, hold the production as satisfied, close the record, and reduce the decree. Then, as regards the future proceeding in the case, perhaps the parties will consider whether they could by minute of admissions place the case in shape for decision and renounce probation, but should that not be done it would be necessary that there should be an allowance of proof.

The Court pronounced the following interlocutor:—

> "The Lords having considered the reclaiming-note for James Reid Stewart and others against the interlocutor of Lord Stormonth Darling dated 18th July 1894, and heard counsel for the parties, Adhere to the said interlocutor in so far as it repels the defences, so far as preliminary, reserving them as defences on the merits; allow the defender, Alexander Moore, to satisfy the production as regards the interlocutor or decree called for in the summons, and hold the production satisfied so far as regards the said interlocutor or decree; hold the record already closed as the record on the merits, and reduce the said interlocutor or decree: *Quoad ultra* recal the interlocutor reclaimed against *in hoc statu*, and continue the cause: Find the defenders, James Reid Stewart and others, liable to the pursuers in expenses from the date of the interlocutor reclaimed against," &c.

The directors subsequently lodged a minute consenting to the reduction of the bills of sale and to declarator that they were not entitled to any preferential ranking.

Counsel for the Pursuers—Ure—Salvesen. Agents—Hamilton, Kinnear, & Beatson, W.S.

Counsel for the Directors—Asher, Q.C.—Aitken. Agent—P. Gardiner Gillespie, S.S.C.

Counsel for the Liquidator—C. S. Dickson—Younger. Agents—Webster, Will, & Ritchie, S.S.C.

Friday, December 7.

SECOND DIVISION.

[Lord Low, Ordinary.

RICHARD'S TRUSTEES *v.* ROLAND.

Succession—Vesting—No Gift Apart from Direction to Pay—Destination to Children, whom Failing their Issue.

A testator directed his trustees to hold the residue of his estate so long as his wife survived him, and from the free annual income to pay her an annuity of £2000, and to divide the balance of the income equally among his children *nominatim*. On the death