CUMBRIAN NEWSPAPERS GROUP LTD

v.

CUMBERLAND WESTMORLAND HERALD NEWSPAPER AND PRINTING CO. LTD.

Chancery Division (1987) Ch. 1

The application of Section 125 of the Companies Code requires the satisfaction of a two-limb test:

1. There must be "rights attached to shares included in a class of shares"; and
2. There must be "variation or abrogation of those rights" (s. 125(2), s. 125(3), s. 125(8)).

The decision in *Cumbrian Newspapers* endeavoured to elucidate the requirements of the first limb. The relevant facts can be briefly stated: the plaintiff company acquired a 10.7% holding of the issued ordinary share capital in the defendant company in 1968. As part of the arrangement of a partial merger of their activities to maximise their respective advertising revenues the defendant adopted articles of association granting the plaintiff the following rights:

1. Rights in respect of unissued rights;
2. Rights of pre-emption over the other ordinary shares of the defendant; and
3. Whilst it held 10% of the issued ordinary capital, the right to appoint a director to the defendant company's board.

The plaintiff company argued that a proposed cancellation of these articles by the directors of the defendant company infringed the Companies Act 1985 (U.K.) s. 125, on the basis that the rights were "class rights"[1] and so protected from variation or abrogation without the plaintiff's consent.

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[1] Although the term "class rights" is not specifically used in the legislation it is common terminology amongst the commentators.

In determining this issue, Scott J. divided 'rights' contained in the articles into three categories, examining each in turn to determine its relationship with the concept of "class rights". It is suggested that his approach, whilst prima facie a clarification of the concept of a "class right", has left open some fundamental issues.

With a noticeable absence of Australian case law on the point, the consideration of *Cumbrian Newspapers* in future litigation is inevitable. However its application under the present Companies Code is far less certain. The prima face disparity between the English and New South Wales legislation as well as (and most importantly) internal disparities and discrepancies within the New South Wales Companies Code predicates a difficult task for the courts.

1. *IDENTIFYING CLASS RIGHTS—THE FIRST LIMB*

In *Cumbrian Newspapers*, Scott J. identifies three categories of "rights" and determines which may be characterized as a 'class right'. These categories are:

(a) Rights or benefits annexed to particular shares.
(b) Rights or benefits conferred on individuals not in the capacity of member or shareholder of the company, but for ulterior reasons, connected with the administration of the company's affairs or the conduct of its business.
(c) Rights or benefits that although not attached to any particular shares, are nonetheless conferred on the beneficiary in the capacity of member or shareholder of the company.

The "classic example" of the first category[2] are rights to participate in surplus assets on a winding up and dividend rights which are not enjoyed by the holders of other shares. Whilst these examples fall within the traditional understanding of 'class rights' they are annexed specifically to the shares which by their very nature distinguishes them from other class rights. Scott J. goes on to discuss defeasible rights where upon alienation of the shares such rights are lost. The "defeasance of rights", states Scott J., "would not *of itself* prevent the rights, pre-alienation, from being properly described as rights attached to a class of shares".[3]

It may be asked what Scott J. meant by "would not of itself prevent the rights" being described as class rights. What more would be required to remove such rights from the ambit of class rights? It is suggested that the better view is not to consider the words "of itself" as otiose. What they suggest is that although the defeasance of rights per se does not remove such rights from the scope of class rights, it may in certain circumstances reflect the fact that the rights are not accorded in the capacity of member.

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[2] (1987) Ch. 1. at 16.
[3] Ibid.

It might be thought that it goes without saying that if all shareholders have identical rights attached to their particular shares, there is no "class of shares" so as to fall within s. 125. In this sense, a "class" requires, by definition, shares that fall within it and shares that do not.[4] Gower states that "there cannot be class rights unless the memorandum or articles divides the members or the shares into different classes with different rights".[5] Jacobs J. in *Crompton v. Morrine Hall* (1965) 82 W.N. (NSW) 456 made it clear that it will be sufficient if in fact a separation of classes exists even though there is no express division in the memorandum or articles. Gower concedes (at p. 563) that a class may be created by the very issue of the shares.

Members of such a class must turn to s. 126 for "class rights" protection as s. 125 is offered only to classes of shares expressly divided within the memorandum or articles. But s. 126(2) requires that no alteration of such class rights [i.e. a class created by the issue] can be altered without the "consent of the holders of three-quarters of the *issued shares in the company* or with the sanction of a special resolution passed at a meeting of the holders of those shares." If what is meant by "the issued shares in the company" is all such issued shares then it is the general meeting which has control over such variation or abrogation. If it was intended that a "class meeting" should be held then why were the words "issued shares *of the company*" inserted? The insertion of these words (not found in s. 125) may negative any protection for the class. It has also been suggested that further problems arise if the rights accorded the member do not arise from the issue document but rather from a contract regulating the share issue. Surely the shareholders would consider rights arising under the contract as rights attached to the shares.[6]

One problem, however, is whether, if a separate class of shares exists on this criterion, all rights held by members of that class will be regarded as class rights, irrespective of the fact that some rights may be shared by all members of the company. For example, the company's memorandum or articles may establish class 'A' ordinary shares holding one vote per share plus ordinary dividend rights, and class 'B' preference shares with one vote per share plus a 20% cumulative preferential dividend. Clearly the right to a preferential dividend would constitute a class right attracting s. 125 protection but would the voting rights of the preferential shareholders be similarly treated?

Three possible views might be adopted;

(i) once a separate class of shares is objectively ascertained to exist, all rights held by members of the class will be subject to protection under s. 125 of the code as being "rights . . . attached to shares included in a class of shares".

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[4] See discussion of *Bushell* v. *Faith* (1970) AC 1099 by Scott J. (1987) Ch. at p. 17.

[5] Gower, *Principle of Company Law*, 4th Ed. at 562.

[6] See J. Hill in Austin and Vann (eds.) *The Law of Public Company Finance*, at 166.

(ii) An intermediate view might be that once a separate class of shares is found to exist, some, but not all rights held in common by all shareholders will be regarded as class rights. Gower appears to adopt this view,[8] stating that once a special class of shares has been created, any rights relating to dividends, return of capital or voting will be treated as class rights irrespective of whether they are exclusive to the class.

(iii) A third view might be that it only makes sense from a policy point of view to defuse the existence of a class vis-a-vis the particular rights threatened with abrogation or variation. This approach would appear to establish a fluctuating notion of a "class of shares" for the purposes of protection under s. 125 of the code. It is submitted that this approach is suggested by the different wording of the UK provision, i.e.: "rights attached to a class of shares". On this interpretation it could be argued that with respect to voting rights (in the above example), no separate class of shares exists and that therefore the protective mechanism of s. 125 does not operate.

The second category involves "rights or benefits conferred on individuals not in the *capacity* of member or shareholder of the company but for ulterior reasons connected with the administration of the company's affairs or the conduct of its business". (at 16)

In the course of his judgement Scott J. cites *Eley-v-Positive Government Security Life Assurance Company Ltd.*[9] Eley who was appointed company solicitor under a provision of the articles sought to enforce the provision as a contract.

The rights accorded by the provision were not "*attached*" to particular shares nor did they satisfy Scott J.'s third category of conferral of rights in the capacity as member.

The facts in *Eley* are simplistic in the present context as Eley was not a member when the appointment was made. Scott J. concedes that the conclusion "might not be so easy" where "the individual had been issued with shares in the company at the same time and as part of the same broad arrangement under which the article in question had been adopted."[10]

The third category Scott J. identifies must logically follow from the second for in the second Scott J. requires a nexus between the right and the party's capacity as member or shareholder.

The third category presents more difficulty in analysis than the former two. This category would cover:

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[8] Supra footnote 5 at 563.

[9] (1875) 1 Ex.D.20.

[10] This will be an issue of evidence and intention. See p. 16 of Scott J.'s judgment.

> "rights or benefits that, although not attached to any particular shares, were nonetheless conferred on the beneficiary in the capacity of member or shareholder of the company". (at 16-17)

Are these class rights? Scott J. cites *Bushell* v. *Faith*[11] and *Rayfield* v. *Hands*[12] in support of his judgment that this was in fact a category encompassing class rights.

The popular view of *Bushell* v. *Faith* concerns the validity of weighted voting rights over the statutory power of removal of directors. In that case the company's articles provided that, in the event of a proposed resolution at a general meeting to remove a director, any shares so held by that director would have three votes per share.

This was not a case concerning the alteration of class rights, rather the validity of the article itself. Scott J. cites the case as an example of rights conferred in the capacity of member or shareholder.

Therefore on Scott J.'s reasoning, had the two other directors endeavoured to alter the article (which vested the three votes per share in the director) then that would have amounted to a variation of that director's rights conferred upon him as member, though not annexed to any particular shares.

What if the directors were also the only shareholders? On the facts, the sister to the plaintiff was a shareholder but not a director, hence Scott J. determined that the relevant article created two classes of shareholder: those that were for the time being directors and those that were not. If all the shareholders had been directors then on one interpretation of Scott J.'s first category there could be no class as the class incorporates the whole body of shareholders.

Scott J. interprets *Rayfield* v. *Hands* along same lines finding in that case the two classes were "identifiable not by reference to their respective ownership of particular shares but by reference to the office held by [the defendants]".

This approach, it is submitted, further supports the argument that classes can be different for different purposes, depending upon the right which is being varied or abrogated. As shares could move in and out of a class, they could hold different rights at different times. It is the right itself which determines the ambit of the class. It can be interpreted from Scott J.'s judgment that the identification of a right will not of itself resolve the issue. That right must be within the limited definition given to a "class right" embodied in Scott J.'s categorical approach. The breadth of that definition may be further limited under s. 125 (NSW). On the facts, it was clear that the rights were not attached to particular shares but were dependent upon the plaintiff holding at least 10 per cent of

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[11] [1970] AC 1099.
[12] [1960] Ch. 1.

the issued ordinary shares. As the rights were acquired in the capacity of member they were held to be class rights under Scott J.'s third category.

The Companies Act (NSW) s. 125 and Scott J.'s third category of rights

Does this third category identified by Scott J. have any place in the present Australian law?

The terminology in s. 125(2)(a) and s. 125(3)(a), as mentioned above, contrasts with the English s. 125, in that it provides protection to "rights attached to shares *included in class of share*" which *prima facie* appears to have a different ambit to "rights attached to a class of shares" (UK). What may appear to be merely a subtle change of wording, at least on one interpretation, could have considerable consequences.

There are primarily two interpretations of the meaning and effect of this phrase. Both are subject to the disparity in language between s. 125, Reg. 4 of Table A and s. 73(5).

The wording requires the rights to be "attached" to shares included in a class of shares. It might be argued that this draws an analogy to Scott J.'s first category of rights attached to particular shares which hence form a class. The effect of this is to limit "class rights" considerably by definition to Scott J.'s first category, by excluding Scott J.'s third category. Yet it expands the operation of s. 125 within the first category as it affords protection to all rights within the class, not merely those rights distinguishing share X or member Y from other classes.

2. *CRITICISM*

However, this approach does require the judicial insertion of the word "particular"—"rights attached to [particular] shares", for otherwise the proposition has little justification. It would be incorrect to state that rights within Scott J.'s third category or rights which are defeasible by nature are not in some way annexed to the shares. There is no fiction in drawing a link between a member and his/her shares where the right granted is granted to a member in that capacity. The concept of shares is immediately implicated. They are a condition to the existence of the right.

The above criticism goes towards the submission that the phrase in s. 125 presupposes the existence of a class conditional upon "rights attached to shares". Again the word "attached" is the definitional pivot. It is submitted that "attachment" is not to be so narrowly interpreted as to require a statement that right A be attached to share X.

Hence, on this interpretation, s. 125(2)(a), and (3)(a) are not directed to the finding of a class, but rather are intended to oust legislatively the category Scott J. excluded judicially; i.e. rights not attached to "particular shares" nor attached to members in that capacity. Section 125 thus requires a nexus between the share and the member so as to ensure that only members vested with such rights in their CAPACITY as member (i.e. satisfying the nexus criterion) can exert their interests

upon the company. This approach balances the protection of the member with the possibilities of abuse by a class under s. 125. With respect, it is this justification which better supports the reasoning of Scott J. to the position in NSW.

This broader interpretation of s. 125 also receives support from the wording in Art. 4(1) of Table A, which is akin to s. 125(UK).

> "If at any time share capital is divided into different classes of shares, *the rights attached to any class* . . ." and also by analogy s. 73(5).

3. *CONCLUSION*

While the reasoning in *Cumbrian Newspapers* is somewhat superficial, especially in light of s. 125 (NSW), it has elucidated the problems which have long remained dormant and unexplored. Whilst the judgment does not go into sufficient depth to satisfy these qualms, such matters were not in issue before Scott J. And yet, despite the limits to Scott J.'s categorical approach it appears that the issues herein raised can be facilitated by it.

Its relevance to Australian law will depend primarily on the Court's interpretation of the s. 125 phrase "rights . . . attached to shares included in a class of shares".

It is suggested that in light of article 4 of Table A and s. 73(5) and the above interpretation of the word "attached" (in the broader context), the object of s. 125 is parallel to that behind the judgment of Scott J. i.e. the requirement of some nexus between the member and the right to ensure that only those members "affected" by a variance or abrogation to a right held in their capacity as shareholders (once identified) have the right to complain or even reject the proposed alteration.

This follows analogously from the rule in *Foss* v. *Harbottle* and specifically the policy and purpose behind the common law interpretation of the Articles as a contract and its extension under s. 78(1).

The limits on the concept of "class rights" are a balance between protection of the class and abuse of veto by the class. It is not any right which can be vetoed by the class but only those rights inseverable from the creation of such a class.

Hence, whilst s. 125 (NSW) appears to limit the doctrine of class rights to the first of Scott J.'s categories and yet extend its ambit of operation within that category, on closer examination, it is suggested, there is sufficient manoeuvrability for the courts to sidestep what must otherwise be an artificial construction limiting greatly the rights and obligations of members acting as shareholders.

The second limb of s. 125, i.e. the variation and/or abrogation of class rights (once identified) has already been very narrowly defined.[13]

[13] See *White* v. *Bristol Aeroplane Company* [1953] Ch. 65 at 74-76; *Greenhaigh* v. *Aderne Cinema's Ltd* [1951] Ch. 286.

To define "class rights" under s. 125 in the manner proposed above will avoid rendering s. 125 an ineffective last resort.

CRAIG ALLAN CARRACHER
Second Year Student