Privy Council Appeal No. 39 *of* 1964

J. M. Construction Company Limited and another – – – *Appellants*

v.

Hutt Timber and Hardware Company Limited – – – *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 14TH DECEMBER 1964

Present at the Hearing:
LORD REID.
LORD EVERSHED.
LORD PEARCE.
LORD UPJOHN.
LORD WILBERFORCE.
[*Delivered by* LORD UPJOHN]

The appellant companies, two of three plaintiffs in the action, are respectively builders and builders' merchants and ever since 1949 when they were incorporated have purchased their supplies from the respondent company, defendant in the action, who are builders' suppliers. They did so upon the terms that they would be entitled to some rebate on the purchases they made calculated at the end of each trading year of the respondent company, which ended on the 30th November, by reference to the trading surplus of the respondent company and the amount of purchases made by the appellant companies. Rebates were regularly declared by the respondent company and no question arises as to the calculation of the amount of the rebate for any relevant year. The sole question is whether the appellant companies are entitled to be treated as creditors for the amount of each annual rebate so declared for the relevant years ending on 30th November 1957 to 1960 inclusive and so to judgment for those amounts as was held by Leicester J. in the Supreme Court of New Zealand, or whether as held by the Court of Appeal of New Zealand they were entitled to no more than to be issued (if they so wished) with ordinary shares in the respondent company, to be treated as fully paid, to the nominal amount of the rebate due. The appellant companies were in fact allotted such fully paid shares to the amount of the declared rebate annually for those years and entered on the share register of the respondent company accordingly; but they repudiated such allotments as being made without their consent and as this was not disputed the respondent company does not challenge that part of the order made by Leicester J. and affirmed by the Court of Appeal that the share register of the respondent company must accordingly be rectified by expunging the names of the appellant companies therefrom in respect of such allotments.

The third plaintiff, R. O. Slacke Ltd., also a builders' merchant has not joined in the appeal before their Lordships so that no question arises with regard to the judgment of the Court of Appeal against that plaintiff.

The sole question in issue, already stated, is one of fact and depends entirely on the proper inference to be drawn from the course of trading over the years from the time the respondent company was incorporated in 1943 until 1958. The facts have been very fully reviewed by Leicester J. and in the Court of Appeal and their Lordships propose to state only those facts strictly necessary to their judgment.

It is quite clear that the respondent company was incorporated as an ordinary trading company with appropriate Articles of Association but was in fact treated as though it was a co-operative company or mutual association; that is to say a company which makes no profits but returns its trading surpluses to its members by way of rebate or discount. As Leicester J. said—" Although not registered as a co-operative concern it has operated from its inception upon such a basis and the method of rebating to shareholders was in existence prior to the 1947 agreement ". All the respondent company's customers, who were either builders or builders' merchants, were shareholders. North P. also dealt with this matter at the beginning of his judgment and pointed out that the genesis of the dispute could be traced to the lax way in which the respondent company's affairs had been conducted and then he stated, and their Lordships entirely agree, that the trouble had arisen from the fact that although the respondent company was formed on conventional lines as a trading company it was treated as virtually a co-operative company and the members appeared to have decided that it would suit them better if profits were distributed among the shareholders in the form of rebates calculated according to the value of the transactions between the customer and the respondent company. Before their Lordships it was not in dispute that from the inception of the scheme in 1943 when the customers, who were also of course shareholders, ordered their supplies from the respondent company, they did so on the terms that the respondent company would distribute its annual trading surplus among its customers calculated according to the value of the transactions of each customer with the respondent company during the year. These rebates were regularly declared (save in 1956 when there was no surplus) by the respondent company's directors, and approved by the shareholder customers at the annual general meeting and credited to each customer's rebate account.

Their Lordships regard the early trading history before the 1947 agreement, to which reference will later be made, as of fundamental importance to the decision of this case. The evidence relating to this period was rather sparse, which is not surprising, having regard to the lapse of time. Mr. Slacke gave evidence to this effect: " The profits were to be paid out to shareholders in cash *pro rata* of their purchases. I cannot remember any reference at that time to payments according to capital contributed. The profits were to be paid out to the builders in cash. They were paid with the previous construction company in cash. That is the way the Hutt Timber and Hardware Co. Ltd. traded between 1943 and 1947 as far as I can remember." Mr. Bowen, the secretary of the respondent company, in answer to the question " To entitle your company to obtain tax exemption under the section regarding rebates it was essential that the rebate be the actual property of the recipients? ", replied " That goes without saying; once you declare a rebate you immediately transfer the right from the company to whom it is due." This was said in reference to the New Zealand Land and Income Tax Act 1954 which will be mentioned later. The early Minute Books of the respondent company also show that the rebate was regarded as a true credit. See for example the directors' resolution 12th March 1945: " It was left to the secretary to credit the rebate at a rate of £600 per month as he thinks best." Mr. Jones also gave evidence that the profits would be rebated to the builder customers concerned annually. Mr. Hooper, the director and secretary of the first appellant company, said—" By co-operative I mean they paid rebates back to their shareholders." This evidence is supported by the recitals in the 1947 agreement and by the general tenor of its operative clauses. Their Lordships are of opinion that these recitals are of great importance as being good evidence of the facts nearly 20 years ago and they cannot accept the submission that such recitals should be rejected as evidence. That some repayments of rebates in cash were made to the customers before 1947 was also conceded in argument.

That rebates should be paid in cash is in accordance with normal commercial practice and commonsense. A co-operative or mutual company does not operate to make a profit; it charges its customers prices intended to ensure that it can discharge its own obligations to its suppliers, to pay wages and reasonable directors' fees, to provide for maintenance, depreciation and other proper allowances; the surplus is returned to the customers normally in cash,

or as a credit available against future purchases. Furthermore the practice that was adopted with regard to income tax strongly supports the view that the rebates declared annually were regarded by the respondent company and its customers as legally due to the customers as creditors. This practice was simply that the respondent company, treating itself as a mutual association, making no profits but distributing its annual surpluses among its customers applied the provisions of the New Zealand Land and Income Tax Act of 1954 section 145, by agreement with the Tax Department, with the result that it paid no tax but the sums distributed whether in cash or by way of issue of fully paid shares were treated as subject to income tax in the hands of the recipient companies. If the contentions of the respondent company are right it is conceded that its action in paying no income tax was wholly wrong and illegal; the respondent company over a long period has failed to pay tax which it ought to have paid and its customers have been subject to tax which they ought never to have paid. Their Lordships would be reluctant to reach such a conclusion unless the facts clearly warranted it. Their Lordships are satisfied that the proper inference to be drawn from the evidence is that before 1947 the customer/shareholder dealt with the respondent company on the footing that on placing an order he would be entitled to a rebate or discount in this sense that at the end of the year he would be entitled to a legal credit to be discharged in cash or available to set off against future purchases.

By the year 1947 the respondent company was beginning to expand rapidly and it was becoming very inconvenient to make rebates in cash, for the respondent company was short of it. So in 1947 the shareholders entered into an agreement, dated 28th November of that year, which is set out in full in the judgment of Leicester J., so that it is not necessary to do more than quote the recitals for the reasons just given and to state the relevant effect of that agreement. It was made between the builders whose names appeared in the schedule thereto and the respondent company and the recitals, so far as relevant, were these: " Whereas the Builders are respectively engaged in the building trade and purchase supplies required for their respective businesses from the Company And Whereas the Company annually rebates to the Builders its surplus revenue making such rebate proportionately according to the transactions of the respective Builders with the Company during the year current when the rebate is made And Whereas such rebates have no relation to the capital subscribed and in consequence the larger investors are at a disadvantage in that no dividend bonus or other payment is made to them in respect of capital contributed by them And Whereas the Company is indebted to its bankers and is desirous of increasing its capital and of retaining and transferring to capital account a proportion of the funds rebateable to the Builders." And then followed the operative clauses which so far as relevant may be summarised thus: (i) that a dividend might be paid out of the profits at a rate to be fixed by the directors; (ii) that all surplus revenue of the company after making provision for dividend should be rebated to the Builders in proportion to their respective transactions with the company; (iii) the moneys to be rebated to the Builders should be credited to them in the books of the company and so far as not required for capitalisation in accordance with the agreement should be paid in cash to the respective Builders entitled thereto; (iv) there followed some rather complicated provisions whereby the Company would increase its capital annually and the directors might apply part of the rebateable funds due to the Builders in using them for subscription to new shares to be issued from time to time by the Company; the Builders agreed to subscribe for such additional shares and to authorise the company to apply the funds standing to their respective credits in rebate account against liability for calls in respect thereof; (v) clause 7 is particularly important in that it provided that the process of increasing the capital of the company should be repeated at the end of each financial year until the capital of the company should reach £60,000 or such larger amount as the directors might consider necessary on consideration of the company's financial position when that figure had been reached. Clause 8 provided that any customer/shareholder would only transfer its shares to another intending customer on the footing that the transferee would agree to be bound by the agreement.

The appellant companies were incorporated in 1949 to take over the business interests of W. E. Jones Ltd., and as required by the 1947 agreement transfers of shares in the respondent company were made to them. They never in fact subscribed to the 1947 agreement in terms as required by that agreement, one reason, given in evidence, for not doing so was stated to be that the agreement was about to come to an end because, as the fact was, the capital was increased to £60,000 in the year 1950. Whether that be the true reason or not their Lordships are satisfied, as were both courts below, that the appellant companies knew of the 1947 agreement and initially traded with the respondent company on the footing that it applied to their transactions with the respondent company, that is to say, that the rebate to which they would be entitled as a result of their trading transactions with the respondent company would be applied as provided in that agreement. Their Lordships are content to treat this appeal as though the appellant companies were parties to that agreement.

After the execution of the agreement a dividend of 3% was paid to shareholders in respect of their shareholding for the year ending 30th November 1948 and 2½% was paid for the year ending 30th November 1949 but no further dividends were ever paid. From 1949 to 1951 rebates due to customer/shareholders in respect of their purchases were paid partly in cash and partly by an allotment of shares as provided by the agreement. The last cash rebate, for the year ended 30th November 1951, was paid in 1953. Thereafter four annual rebates were declared and satisfied wholly by the allotment of shares in the respondent company treated as fully paid up, which were accepted by the appellant companies though reluctantly, but it has not been suggested that they could re-open such allotments.

As Leicester J. said in his judgment, from 1953–1958 the respondent company entered on an elaborate scheme of expansion by the purchase of mills, forests, and rural property, a sum of almost £500,000 being expended. This had to be financed by overdrafts so that the Bank refused to allow the respondent company to make any repayment of rebates to its customers in cash. This made the annual issue and allotment of shares to the customer/shareholders larger and progressively less attractive because the shares were becoming less valuable and less saleable. This situation had an important effect on the taxation position. When it was thought that the value of the shares so issued annually under the arrangements already mentioned were decreasing, the Tax Department, rightly or wrongly, were prepared, for the purposes of assessment of tax upon the recipients of the shares, to accept a much smaller value than their nominal value. At one stage it appears the shares of a nominal value of £1 were treated as worth 1s. Nevertheless this situation and the failure of the respondent company to pay any part of the rebate in cash proved unsatisfactory to the appellant companies and led to some acrimonious correspondence with the respondent company which is fully set out in the judgment of Leicester J. This led finally to the important letter of 2nd July 1958 by the solicitors of the appellant companies to the respondent company, which finally terminated the right of the respondent company to apply any part of the rebate in paying up shares allotted to the appellant companies, unless the 1947 agreement or some agreement based on its provisions was at that date still continuing in operation and rendered that letter nugatory.

The continued operation at the date of that letter of the 1947 Agreement was the vital issue in the court of first instance, apart from certain questions of estoppel and waiver, which have been abandoned by the respondent company, and it was strongly urged before their Lordships that it has continued to operate throughout the relevant period possibly with variations or as an agreement, based on the provisions of the 1947 agreement, to be inferred from the conduct of the parties. Leicester J. in the court of first instance and all the judges of the Court of Appeal have reached the conclusion that the 1947 Agreement had long since ceased to operate as such before 1958. Their reasons for reaching this conclusion do not entirely coincide but their Lordships do not think it necessary to pursue this matter further, for they agree that the 1947 Agreement has long since

ceased to operate. Their Lordships think it sufficient to say that, as the directors never fixed any larger figure than £60,000 under the provisions of clause 7, the Agreement probably came to an end in 1950, but they also desire to adopt the reasoning of North P. on this matter when he said: " . . . it seems to me clear from the reading of the evidence that the company was no longer acting on that agreement but on the contrary the directors were relying on their powers of persuasion as each annual meeting took place. The circular letter of 20th July 1955 confirms the view I take of the matter." The circular letter (set out in full in his Lordship's judgment) does indeed confirm the President's view. Their Lordships are also of opinion that the subsequent conduct of the parties is not such as to make it possible to infer any continuing agreement based on the 1947 agreement after its termination.

It follows that as from receipt of the letter of 2nd July 1958 all authority to apply the annual rebate due to the appellant companies in subscription for new shares was revoked and the sole question as stated at the outset of their Lordships' judgment, remains to be solved.

Before their Lordships, very great stress was laid on the respondent company's arrangements with its Bank whereby no overdraft facilities would be granted if any rebates were paid in cash, and it was argued that any agreement thereafter to pay rebates in cash could not be inferred or even that such an agreement might be a breach of the agreement with the Bank. Their Lordships think too much emphasis has been placed in argument on the phrase to pay " in cash ". A supplier is perfectly entitled to agree with a customer to give him a credit rebate upon which the customer is entitled to sue as a creditor though the supplier may well know and so may the customer, as in this case, that the Bank may not honour a cheque in his favour. There may be other ways of paying cash without resort to the Bank or the supplier may have other means of enforcing payment.

For the reasons already given their Lordships are satisfied that the original rebate arrangement was a purely trading arrangement and a legal right to a rebate as a creditor, no doubt to be quantified later when the trading surplus of the respondent company for the relevant trading year was known, was acquired when an order was placed; this right was never varied save by the 1947 Agreement by which the appellant companies were bound. When that Agreement came to an end the appellant companies agreed for some years, year by year, by their conduct to accept payment of their rebate by permitting it to be applied in subscription to shares. After July 1958 they withdrew any authority so to apply their rebates and it seems to their Lordships clear that the annual rebates thereafter, which the evidence established were credited in the books of the respondent company to the appellant companies, must be treated as legally due upon the terms of the original trading arrangement.

It seems to their Lordships, with all respect to the judgments in the Court of Appeal that the answer must be, as Leicester J. held, that the appellant companies are entitled to be treated as creditors for the amounts of the annual rebates duly declared and to judgment for those amounts.

As their Lordships' judgment is based upon their view of the importance of the original trading terms before the 1947 Agreement and this matter was not greatly canvassed in the Court below their Lordships do not think it necessary to examine in detail the full and careful judgments of North P. or Turner J. in the Court of Appeal who reached a contrary conclusion as to the inference to be drawn from the facts, based on the view that the appellant companies rights rested on their rights as shareholders and not customers.

For these reasons their Lordships will humbly advise Her Majesty that the appeal of the two appellant companies should be allowed. That the judgment of Leicester J. in favour of the appellant J. M. Construction Co. Ltd. in the sum of £3,203 and in favour of the appellant Jones Timber Co. Ltd. in the sum of £9,867 against the respondent company be restored with costs of the appellant companies before Leicester J. and in the Court of Appeal. The respondent company must pay the costs of the appeal.

(91232) Wt. 8069/113 90 1/65 Hw.

In the Privy Council

J. M. CONSTRUCTION COMPANY LTD. AND ANOTHER

v.

HUTT TIMBER AND HARDWARE COMPANY LTD.

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LORD UPJOHN

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