after receipt of all relevant documents and payments and will rank equally with the existing ordinary shares of the company". The fourth condition required the company to apply for Stock Exchange listing as and when shares were issued pursuant to the option. The form of "Application for Shares" alongside the conditions which the option holder was required to complete on the exercise of his options ran as follows:-

> "I/We ... hereby exercise my/our option for ..... ordinary fully paid shares of $1.00 each in Forsayth Oil & Gas N.L. and I/we enclose (being application and allotment money) payment at the rate of 25 cents per share $...."

In February 1983 the Directors circularised the shareholders to the effect that they had:-

> "resolved to restructure the capital base of your Company subject to obtaining shareholder approval and subject to the Supreme Court ratifying the restructure. ... The net effect can possibly be best expressed in the form of the following example:-
>
> | **Current Holding** | **Restructured Holding** |
> |---|---|
> | 10,000 fully paid $1.00 shares | 1,000 fully paid 25 cent shares |
>
> ... Shareholders will be asked to authorise the Company to offer optionholders a new option in lieu of those currently held. Optionholders are to be offered one new option to acquire one fully paid 25 cent share at an exercise price of 20 cents per option for every ten options to acquire $1.00 fully paid shares currently held. The expiry date of this new option will be the 31st December 1985 so that the optionholders are not disadvantaged by the capital restructure."

On 15th March 1983 a special resolution was passed in the following form, leaving out of account for the sake of simplicity the partly paid shares which are not relevant for present purposes:-

> "It was resolved that ... pursuant to Articles 34 and 35 of the Articles of the Company ... the paid up capital of the Company be reduced from $127,104,644.36 (comprising 112,364,727 fully paid shares of $1.00 each ...) to $3,179,190.13 (comprising 11,236,473 fully paid shares of 25 cents each ...) by cancelling the sum of $123,925,454.23 being up paid capital which is lost and is also unrepresented by available assets to the extent of 0.975 cents per share on each of the fully paid shares ..."

The resolution was passed by over 90% of those voting.

It was also resolved that an option holder should be offered one option to acquire one fully paid 25 cent share, exercisable on or before 31st December 1985 at an exercise price of 20 cents per option, for every ten options currently held.

It is apparent from the form of the first of these resolutions that its effect was two fold. First, each fully paid ordinary share was written down in nominal value from $1.00 to 0.025 cents; and secondly every ten shares were consolidated into one share, so that the resultant nominal value of the share became 0.25 cents. There was, in effect, a reduction of capital followed by a consolidation. The reference in the resolution to Article 35, which relates to sub-division of shares, would seem to be a mistake for Article 30; no question of sub-division arose.

On 16th May 1983 the Supreme Court of New South Wales ordered that such reduction of capital should be confirmed. Thereafter some 88% of the option holders accepted the company's offer.

In planning the restructuring of the capital of Forsayth the Directors seem not to have considered whether such restructuring might affect the position of the option holders *vis-a-vis* the existing shareholders. The reason for this was that the options appeared to be worthless, since an option holder had to pay 25 cents to acquire a share which could only be marketed at 2 cents. The option holders were not asked to concur in any variation of their existing option rights, but were merely offered substituted option rights if they cared to accept them.

Shortly after the restructuring of the company's capital, the company's prospects improved. Its shares more than doubled in value by comparison with the early 1983 price. A 25 cent share (representing ten of the previous $1.00 shares) was traded in August 1984 at 45 to 50 cents a share.

In the meantime Livia had become the holder of 1,272,170 options. On 13th April 1984, that is to say two and a half months before the options ran out, it wrote to Forsayth with the relevant transfers and requested the issue of a Certificate for 1,272,170 options. On 9th May Forsayth replied that Livia was only entitled to call for one 25 cent share at a cost of 20 cents, for each ten options. On the following day Forsayth issued an Originating Summons for the purpose of defining Livia's rights. On 29th May Forsayth sent Livia an Option Certificate for only 127,217 options, expressed to be exercisable at 20 cents per 25 cent share. On 30th May Livia purported to exercise its options on the original terms, requiring the issue of 1,272,170 shares of $1.00 each and enclosing cheques for $318,042.50, being at the

rate of 25 cents per share. On 3rd August 1984 Livia issued its own proceedings, which were later consolidated with Forsayth's action.

It is apparent that the reduction in the nominal value of a share was *prima facie* to the disadvantage of an existing shareholder *vis-a-vis* an option holder, to the extent that the reduction diminished the existing shareholder's voting rights and winding-up rights (both being dependent on capital credited as paid up); the consolidation of ten shares into one share was also *prima facie* to the disadvantage of an existing shareholder in terms of dividend, since under the Articles shares ranked equally for dividend.

The existence of an option to take up shares in a company does not by itself impose a fetter on the exercise by the company of the powers conferred on it by the Articles in relation to its share capital. Short of fraud, the company remains at liberty to increase or reduce its capital, and to consolidate or sub-divide its shares. A re-organisation of capital may affect option holders. An increase in the issued capital may dilute their option rights. So may a sub-division of shares. *Per contra*, a consolidation of existing shares may result in a proportionate increase in the amount of the equity represented by an option which is exercised. When options are issued, the company and the prospective option holder have a choice. They may decide to take no account of the possibility of a future change in the company's capital. This has obvious risks for the option holder but it has no unavoidable risks for existing shareholders because it is their choice, or the choice of the Directors appointed by them, whether the capital remains the same or is restructured. If the option holder requires protection, as is obviously prudent, or if the company wishes to retain full liberty of action without altering the balance between option holders and shareholders, there are various devices which can be adopted to meet the situation. The option contract can contain a provision that, if there is any change in the capital structure of the company, the terms of the options shall be adjusted in such manner as the auditors of the company shall certify in their opinion to be fair and reasonable; or as the parties may agree and in default of agreement as may be certified by a nominated accountant to be fair and reasonable; or the company may covenant to give the option holder three months' notice of any proposed capital restructuring, so that he can decide in advance whether to avoid prejudice by exercising the option; or the company may agree not to issue new shares, or to consolidate shares, or to alter rights or otherwise re-organise the capital in a way which would or might detract from the value of the option;

or it may be possible to devise a mathematical formula which would take account of capital restructuring. All these devices, except the last, feature in the English *Encyclopaedia of Forms and Precedents*, 4th Edition, (1966) Volume 5, pages 818 *et seq*. Such forms are mostly devised for the purpose of protecting the option holder. The shareholders in a company are in a position to protect themselves as they have the choice whether or not, and how, to restructure the company without causing themselves damage.

The matter came first before the Honourable Mr. Justice Franklyn, who held that Livia was entitled to be issued with 1,272,170 fully paid shares of $1.00 each at an exercise price of 25 cents per share. Forsayth appealed to the Full Court, which by a majority upheld Franklyn J.'s decision, subject to a minor variation to the terms of the order designed to preserve any defences which might be available to Forsayth in respect of any claim by Livia for specific performance. Forsayth now appeals with leave of the Full Court.

Forsayth's case as argued before their Lordships embraced three propositions, with which their Lordships will deal in the order in which they were presented.

(1) "A term should be implied in the option contract that the entitlement of the optionholder remained open for acceptance until 1st June 1984 or until such earlier time as the Appellant, in accordance with its Memorandum and Articles of Association, altered its capital so that the ordinary shares of the Appellant ceased to have a nominal value of $1.00 each." (Paragraph 71 of Appellant's case).

Livia's option rights had therefore lapsed before exercise.

(2) "The reduction of capital caused a *pro rata* reduction in the entitlement of optionholders to subscribe for shares in the Appellant proportionate to the reduction of capital, so that optionholders were entitled upon the exercise of their options to the same number of shares as they would have been entitled to if they had exercised their options immediately prior to the reduction of capital of 15th March 1983." (Paragraph 38 of Appellant's case).

Livia was therefore entitled to one 25 cent share for every ten option rights.

(3) "After the reduction of capital an optionholder was entitled to receive upon the exercise of

> his option in accordance with its terms a number of shares equal to the number of options exercised by him but equal in all respects to the existing ordinary shares of the Appellant including, *inter alia*, their par or nominal value." (Paragraph 39 of Appellant's case).

Livia was therefore entitled to one 25 cent share for each option right.

First proposition

Their Lordships are unable to accept this proposition. It would mean that the company in general meeting could at any time have unilaterally defeated the rights of the option holders by a simple resolution sub-dividing each dollar share into two 50 cent shares, or consolidating every two $1.00 shares into one $2.00 share, so that there were no $1.00 shares authorised or in issue. It is an unattractive argument. It imposes a totally unnecessary qualification on the terms of the contract, which states explicitly that an option may be exercised until 1st June 1984. The argument appears to be based on the condition that shares issued on the exercise of options "will rank equally with the existing ordinary shares of the company". That condition only means that there are to be no special rights attached to the issued ordinary shares by comparison with ordinary shares falling to be issued on the exercise of the option. The proposition contended for has nothing to commend it.

Second Proposition

This was the proposition principally advocated by Forsayth before their Lordships, although chronologically it took second place in the proceedings. It was the proposition accepted by the Honourable Mr. Justice Wallace in his dissenting judgment.

The basis of the argument is that the options were issued subject to the company's Memorandum and Articles of Association and therefore subject to such use as the company might make of its powers to reorganise its capital. Therefore, as the company reorganised its capital so that the holder of ten shares of $1.00 each became entitled instead to one share of 25 cents, (i.e. 1/40 of his previous holding in terms of nominal value) so also an option holder must suffer a like reduction to 1/40 of his former option rights. Forsayth concedes that, in order to preserve the discount to which Livia as an option holder was entitled, the exercise price might have to be reduced to 6.25 cents per share, compared with 20 cents at one time claimed. Alternatively, a similar reduction in the rights of the option holder, in line with the alteration in the rights of a shareholder consequent upon the re-organisation of the company's

capital, ought to be implied into the option as a matter of commercial sense, so as to prevent the rights of option holders being increased (it is said) forty-fold.

Their Lordships are not able to accept this proposition. The option is clear in its terms. The contract contains no provision for variation in the event of a reconstruction of the company. No power was reserved by the company to alter the terms of the options unilaterally. Nor did the company seek the prior agreement of the option holders to a novation of the option contracts. If the re-organisation of the company's capital has occasioned a disadvantage to the shareholders *vis-a-vis* the option holders, it is a misfortune which the shareholders brought upon themselves. There is no need to imply any term into the contract as a matter of business sense. The option left the company free to increase or reduce its capital, to increase the number of shares by sub-division and to reduce the number of shares by consolidation. If the company had increased its capital and so diluted the potential rights of the option holders, the option holders could not have complained; see *Hirsch & Co. v. Burns* 77 L.T. 377. Short of fraud, the company was free to re-organise its capital as it thought fit, with such advantages or disadvantages as might ensue to the option holders. The company could have protected itself as it thought fit when it decided the terms upon which the options should be granted. It elected not to do so, and indeed it did not need to do so because the whip-hand always lay with the company, which alone could decide whether or not to re-organise its capital.

Third Proposition

This is merely an alternative implication which Forsayth seeks to insert into the terms of the option contract, giving Livia the same number of shares as options, but reducing the nominal value of the shares to 25 cents. There are no sufficient grounds for any such implication, and their Lordships reject the proposition for the same reasons as they rejected the second proposition.

In the opinion of their Lordships Franklyn J. and the Full Court came to the right conclusion for the right reasons. Their Lordships will accordingly humbly advise Her Majesty that the appeal ought to be dismissed. The appellant must pay the costs.

Privy Council Appeal No. 7 of 1985

Forsayth Oil & Gas N.L. *Appellant*

v.

Livia Pty. Ltd. *Respondent*

FROM

THE FULL COURT OF THE SUPREME COURT OF WESTERN AUSTRALIA

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 17TH JUNE 1985

Present at the Hearing:

LORD FRASER OF TULLYBELTON
LORD DIPLOCK
LORD KEITH OF KINKEL
LORD BRIGHTMAN
LORD TEMPLEMAN

*[Delivered by **Lord Brightman**]*

This appeal from the Full Court of the Supreme Court of Western Australia relates to the true construction of an option to apply for and be allotted fully paid shares of $1.00 each in the appellant company, Forsayth Oil & Gas N.L. ("Forsayth") at a discount of 75%. A number of such options were acquired by the respondent company, Livia Pty. Ltd. ("Livia") and later exercised. Prior to the date when Livia exercised its option rights, Forsayth had re-organised its share capital by a process which involved writing down the nominal value of its issued $1.00 shares and consolidating them on a one for ten basis. In the result a holder of ten fully paid $1.00 shares became the holder of only one fully paid 25 cent share. The question which arises is - what effect, if any, such re-organisation of capital had upon the contractual rights of an option holder. It is plain (dependent upon the precise terms of the option contract and of the Articles) that the value of an option to be allotted a share in the capital of a company is capable of being fortuitously increased if prior to the exercise of the option the company reduces the number of its
[20] shares in issue by consolidating two or more shares

into a single share, because the proportion at stake in the income and capital of the company represented by the share option may thereby be correspondingly increased. This lies at the heart of the present dispute.

Forsayth was incorporated in December 1969 in the State of New South Wales with the object of mineral exploration. The original authorised capital consisted of 25 million shares of twenty cents each but, as a result of the creation of further shares and consolidation of shares, the authorised capital had by 1983 come to consist of two hundred million shares of $1.00 each. Under Article 116 shares rank equally for dividend irrespective of the amount paid up or credited as paid up thereon. Under Article 145, on a winding-up surplus assets are distributable in proportion to the capital paid up or which ought to have been paid up thereon. Under Article 57 (as amended) voting rights on a poll are proportionate to the amount paid up on a share.

By 1983 the issued capital of Forsayth had become out of line with the value of its assets as a result of losses sustained. A $1.00 share was selling on the Stock Exchange at only two cents. The Board therefore decided to re-organise the share capital so that it more nearly accorded with the value of the company. At that time Forsayth had in issue some 136 million shares of $1.00 each. About 112 million shares were fully paid, about 3 million were paid up to the extent of 62 cents per share and about 21 million were paid up to the extent of 60 cents per share but had been forfeited for non-payment of calls.

The company had also issued at some time in the past about 70 million options, which were evidenced by Certificates. A Certificate, which was under the seal of the company, certified that the person named was "the registered holder, subject to the Memorandum and Articles of Association of the company, of the undernoted options over fully paid shares of $1.00 each subject to the conditions overleaf". The page overleaf was in two parts. On the right hand side there were set out "Conditions upon which the options may be exercised and the effect of such exercise". On the left hand side there was a form headed "Application for Shares". The first condition provided that each option might be exercised by forwarding to the Registrars "the application for shares duly completed" together with payment of 25 cents as the application and allotment money for each share, at any time prior to 1st June 1984. The second condition provided that options might be transferred by an instrument of transfer at any time prior to 1st June 1984. The third condition provided that "Shares issued on the exercise of options will be allotted