CASE LAW

DIVIDEND LAW – SECTION 376, DIVISIBLE PROFITS AND RESERVES

MARRA DEVELOPMENTS LTD. v. *B. W. ROFE PTY. LTD.*[1]

The main provisions of section 376 of the Companies Act, 1961 (N.S.W.) are:

(1) No dividend shall be payable to the shareholders of any company except out of profits or pursuant to section 60.

(2) Every director or manager of a company who wilfully pays or permits to be paid any dividend out of what he knows is not profits except pursuant to section 60

(a) shall without prejudice to any other liability be guilty of an offence against this Act; and

(b) shall also be liable to the creditors of the company for the amount of the debts due by the company to them respectively to the extent by which the dividends so paid have exceeded the profits and such amount may be recovered by the creditors or the liquidator suing on behalf of the creditors.

There are no parallel English provisions but a somewhat analogous provision appeared in the Limited Liability Act 1855 (U.K.), and cl. 116 of Table A of the Companies Act 1948 (U.K.) provides for an article in similar terms.

However, English courts in construing the Companies Acts discovered a principle of similar effect: that dividends could not be paid out of capital.[2] As a result English courts have in the main been called to construe the meaning of "capital". Indeed, some cases have regarded the limitation that dividends are only payable out of profits as quite distinct and of different effect from the prohibition on paying dividends from capital.[3] However, the two formulae have normally been regarded as expressions of the same principle.[4]

Recently, two major cases have come before Australian courts on the interpretation of section 376, and the principle that dividends shall be payable only from profits. The first of these, *Industrial Equity Ltd.* v. *Blackburn*[5], went to the High Court where it was held, with

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[1] (1977) 1 N.S.W.L.R. 162 (Sheppard, J.); (1977) 2 N.S.W.L.R. 616 (Court of Appeal).

[2] *Re Exchange Banking Co., (Flitcrofts Case)* (1882) 21 Ch. D. 519.

[3] *Bond* v. *Barrow Haematite Steel Company* [1902] 1 Ch. 353 at 365.

[4] See *inter alia Palmers Company Law* (22nd ed. by M. C. Schmitthoff 1976) at 794.

[5] (1978) 52 A.L.J.R. 89; noted in (1978) 8 *Syd.L.R.* 657 (S. Menzies).

Mason, J. giving the leading judgment, that section 376 required that there should at least be profits available at the time of declaration of the dividend, but it was left undecided whether this requirement also applied at the time of payment or satisfaction of the dividend.[6]

That issue then arose in *Marra Developments Ltd.* v. *B. W. Rofe Pty. Ltd.* in which Sheppard, J's decision[7] was reversed by the Court of Appeal.[8] Unfortunately the decision in the former case was not handed down until argument in the latter case had been concluded so that there was little opportunity for discussion of the true extent of the High Court's decision before its application fell to be considered.

Mahoney, J.A. devoted part of his judgment to a review of the general law relating to dividends. However, in so far as it is not immediately relevant to the points in issue it is beyond the scope of this note and the reader is referred to articles on dividend law by B. S. Yamey[9] and R. M. Bryden.[10] In relation to Hutley, J.A's brief comments on the application of section 376 to interim dividends the writer can add nothing to the observations of Stephen Menzies in a prior volume of this journel.[11] Finally, the comments made by Hutley, J.A. and Moffit, P. on the propriety of the action for a declaratory judgment are again outside the scope of this note. In approaching the case the writer seeks the answer to three questions:

(a) Is there a requirement at general law that there be profits available at satisfaction of the dividend sufficient to pay it?

(b) Does section 376 import such a requirement?

(c) On the facts of the case did the reserves represent profits available for distribution?

While additional facts are presented in Part C, the following brief summary is adequate for other purposes.[12] Marra Developments Ltd. (hereinafter called the company) made trading profits in the year to 30th June, 1974, and it was conceded that the profit revealed in the accounts was a true profit capable of supporting the dividend which was declared on 10th December, 1974. This dividend, which fell due immediately on declaration, was not paid. Subsequently, on a revaluation the company wrote down the value of its assets by $21 million so that its accounts for the year to 30th June, 1975, disclosed an accumulated loss of $20 million. The position deteriorated still further in the year to 30th June, 1976.

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[6] *Id.* 93.
[7] (1977) 1 N.S.W.L.R. 162.
[8] (1977) 2 N.S.W.L.R. 616.
[9] B. S. Yamey, "The Case Law Relating to Company Dividends" in W. T. Baxter and S. Davidson, *Studies in Accounting Theory* (2nd ed. 1962) at 428.
[10] R. K. Bryden, "The Law of Dividends" in J. S. Ziegel, *Studies in Canadian Company Law* (1967) at 270.
[11] *Supra* n. 5.
[12] *Supra* n. 8 at 621.

B. W. Rofe Pty. Ltd., which was a shareholder at all material times, began an action in the District Court to recover the dividend as a debt. The company then sought a declaration in the Supreme Court of New South Wales that it had a defence to the action, and in particular that payment was prohibited by section 376. Sheppard, J., at first instance, granted such a declaration. His Honour's decision was reversed in the Court of Appeal, and then leave was granted to appeal to the High Court, but no appeal eventuated.

(A) Is there a requirement at general law that there be profits available at satisfaction of the dividend sufficient to pay it?

Mahoney, J.A. observed that the point was not covered by precedent, and so it was necessary to turn to principle. Firstly, his Honour pointed out that it is not necessarily a violation of principle to pay a dividend when there are no available profits. The rationale of the principle of maintenance of capital is to keep the capital available to meet the liabilities of the company in so far as it is not diminished by expenditure on the objects of the company. Thus a company can pay its just debts out of capital. The question is whether the debt created by the declaration of a dividend is an ordinary debt of the company, or whether it is of a special nature.[13]

His Honour then enumerated various decisions and *dicta* indicating that a declared dividend is a debt at law for which the shareholder may sue: *In re Severn & Wye and Severn Bridge Railway Co.*[14] and *Industrial Equity Ltd.* v. *Blackburn.*[15] Such cases establish that the declaration of a dividend does not of itself constitute the company trustee for the shareholder and that the debt is subject to the Statute of Limitations. His Honour's decision is that the amount of a declared dividend is a debt at law and there is no reason why it should not be regarded as a simple debt without special rules or conditions. The alternative result, his Honour suggested, would lead to chaos and paradox.[16]

It must be recognized that from the point of view of precedent the above argument is predominantly negative. The cases deciding that a declared dividend is a debt were concerned with the application of the Statute of Limitations. In determining the extent of the principle his Honour has concentrated on the words used to describe the debt, rather than on the words used to describe the prohibition. On the whole, the earlier cases say that dividends shall not be *paid* out of capital,[17] though there is occasionally some fluctuation between *paid*

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[13] *Id.* 640.
[14] [1896] 1 Ch. 559.
[15] *Supra* n. 5.
[16] *Supra* n. 8 at 641.
[17] See *inter alia Verner* v. *General and Commercial Investment Trust* [1894] 2 Ch. 239 and *Re National Bank of Wales* [1899] 2 Ch. 629.

and *payable* even in the one case.[18] It is surprising that so little weight was given to the predominant formulation of the prohibition.

(B) Does section 376 import such a requirement?

It is clear that Shepard, J. felt sympathy for the other arguments of the shareholder, but he found that this section was related to section 64, and so operated to prohibit any dissipation of the capital "contrary to the interests of creditors where the company, notwithstanding the declaration of a dividend, had become unprofitable".[19]

On appeal, the interpretation of section 376 was still of crucial importance. All judges first had regard to the meaning of subsection (1). The contention of the company was that the word "payable" in the context meant *paid* or *satisfied*. Moffit, P. and Mahoney, J.A. held that the word is not a term of art and that its meaning will depend on context. However, in the light of the decision in *Industrial Equity Ltd.* v. *Blackburn*[20] it definitely referred to the availability of profits at the time of declaration:

> The prohibition is not against dividends being 'paid' otherwise than out of profits, but against their being 'payable' otherwise than out of profits. The prohibition is certainly directed to the declaration of a dividend — though it is possible that it is also directed to payment. . . .[21]

The above *dictum* of Mason, J. does not define the limitations of the meaning of "payable" as it appears in section 376. His Honour has merely determined that the requirement will apply to one situation at least, and that is the time of declaration of the dividend. However, Mahoney, J.A. and Moffit, P. felt that for "payable" to apply to the time of payment as well it must be given a second distinct meaning.[22] Since such words at general law only applied to the time of declaration, their Honours felt that the subsection should be construed in the same way. If a different meaning had been intended different words would have been used.[23] The conclusion is that subsection (1) does not require that profits be available at payment.

In contrast Hutley, J. A. did not regard the meaning of subsection (1) as a point in issue. Without significant explanation of his reasoning his Honour said:

> what [subsection (1)] means, in relation to a final dividend, is that the laying before this company of a profit and loss account and balance sheet which truly and fairly discloses a profit out of

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[18] *Lagunas Nitrate Co.* v. *Schroeder & Co. & Schmidt* 85 L.T.22.
[19] *Supra* n. 7 at 168.
[20] *Supra* n. 5.
[21] *Id.* 93.
[22] Moffitt, P. seemed to suggest that "payable" in the section was completely defined by precedent, but then his Honour returned to consider if it could bear a second meaning in the context of subsection (2).
[23] *Supra* n. 8 at 642.

which the dividend may be paid is a pre-condition of the shareholders acquiring any right to a dividend.[24]

Thus if the accounts are correct and reveal a profit sufficient to pay the dividend, and the dividend had been declared in accordance with the articles, the shareholder has an irrevocable right to his divident. For Hutley, J.A. the basis of the company's argument was that the debt created by the declaration was effected by supervening illegality through the operation of subsection (2). His Honour, with Moffit, P. agreeing on this point, observed that subsection (2) imposes a duty on directors and managers, but not on the company.[25] Thus if it was correct, as the company argued, that the subsection required available profits at satisfaction, the officers would be prohibited from paying the dividend, but the shareholder would still be able to sue at law to recover the dividend. The dividend would then become a judgment debt and the officers could pay the debt without committing an offence. His Honour felt that the words were not clear enough to take away the rights vested in the shareholders, and drew further support for this narrow construction from the fact that the subsection created a criminal offence.

Mahoney, J.A. simply stated that subsection (2) imposed no new sanctions without considering it fully. However, his Honour did observe that it probably applies to the actual payment of dividends impugned by subsection (1). Thus all judges on appeal felt that subsection (2) was wholely subordinate to subsection (1), and that for the former to apply there must be payment of a dividend with knowledge that dividend has been declared contrary to subsection (1).[26]

Hutley, J.A. then observed that the payment of a dividend contrary to the section may be restrained by an injunction or a declaration, but that a director or a manager, if he is not a shareholder, may not have *locus standi.* This could well produce a "Catch 22" situation since the individual director will only vote as one member of the board in deciding whether to pay the dividend[27].

One reason for the Court's decision is clear — a dividend is an ordinary debt at law, and it takes stronger words than those used to extend the law. However, in the main case law was referred to simply to show that there was no relevant precedent so that it was open for the Court to decide the point on principle. In that regard the Court put considerable emphasis on the following circumstances which would have resulted if the company's submissions were accepted:

(a) There would be a condition subsequent on the legal debt which would be difficult to ascertain, yet rights would vary on the instant that the company ceased to have sufficient profits available.

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[24] *Id.* 622.
[25] *Id.* 623.
[26] *Id.* 620, 623 and 642.
[27] *Id.* 623.

(b) The right to payment would depend on the time of payment. Thus if the company ceased to have available profits while some only of the dividends were unsatisfied the rights of the shareholders would differ fortuitously. Indeed if subsection (2) were to be construed more widely than subsection (1), and on the facts more than one director was empowered to draw dividend cheques, then the right to payment may depend not only on the time of payment, but also on the state of knowledge of the individual directors.[28]

(c) A final dividend would not be irrevocable, "contrary to one of the fundamental understandings of company law".[29] However, it is submitted that the validity of this point depends on a wide interpretation of the term "irrevocable".

(d) Section 218(1)(g) would, in many cases, be superfluous, since a company will often have ceased to have profits prior to winding up. Hutley, J.A. suggested that in such a situation the provision, which is intended to postpone the payment of the dividend, would in fact be the only authority for its payment.[30]

(e) There would be chaos since new accounts would have to be obtained if there was any reason to suspect any deterioration in the company's position, such as if shares held in the company's portfolio of investments were to go into an inexplicable sharemarket slump.[31] However, it is arguable that the result would not be chaotic since in the ordinary course of events the old accounts would be adequate. Where there has been a dramatic change in the company's fortunes or an unusually long delay before payment it may not be thought to be unreasonable to require a new set of accounts. Nevertheless the extreme position of a company required by its articles to divide the whole of its profit demonstrates the validity of their Honours' point. Such a company would require its accounts to be exactly up to date to indicate whether the whole of the profit was still available.

It is submitted that the above reasoning is sufficient to establish that a declared dividend may actually be paid in the absence of available profits. However the judgments of Hutley and Mahoney, JJ.A. further justify these conclusions by elucidation of the expression "payable out of profits". Whereas Hutley, J.A. concentrates on the term "profits" Mahoney, J.A. considers the term "payable".

Profits

The question what is a profit has often been asked, and the answer is usually given in terms of revenue profits and surpluses on paid up capital. However, their Honours ask the question in relation to the

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[28] *Id.* 624.
[29] *Id.* 625.
[30] *Ibid.*
[31] *Id.* 624.

primary meaning of the word rather than the historical origins of the excess. Both recognize, as it is important to keep in mind through the following argument, that a profit is not a specific fund, but rather a balance of accounts.

Hutley, J.A. recognized that if the requirement of available profits means that an account at that instant must reveal a profit sufficient to cover the dividend, then some of the policy objections to the company's argument would apply just as much to the time of declaration as they do to the time of payment.[32] His Honour concluded that it is sufficient if, in the accounts presented, there is a true and sufficient profit disclosed. Thus it would be irrelevant if the company, between accounts and declaration, were to suffer a massive loss:[33]

> . . . [the declared dividend] did not cease to be a declaration payable out of profits because, in respect of an entirely different period, there were crippling losses . . . it is in respect of the period of account, and that period alone, that the question whether there are profits to enable a dividend to be declared has to be determined.[34]

Such an aproach treats the profit as the child of the accounting system and the accounting period. Sheppard, J. supported this approach,[35] and support may also be found in the Canadian decision of *Leclerc Ltd.* v. *Pouliot*:

> . . . such dividend so declared and fixed is irrevocably acquired to the shareholders, *if it corresponds to a real excess of assets over liabilities at the end of the preceding year.*

This aproach seems to be contrary to the *dictum* of Jacobs, J. in *Industrial Equity Ltd.* v. *Blackburn*:

> No dividend can be paid except out of profits, and the impugned dividend and distribution was in fact paid and made. The application of this requirement is not governed by accounting periods or an accounting system.[37]

However, it is submitted that this *dictum* was not meant to be wide enough to cover the present case, and was rather meant as a rebuttal of an argument that the profit for an interim dividend need only have accrued at the end of the period. However, if it is in point, then it is *obiter,* and with respect it is submitted that Hutley, J.A's approach is to be preferred. The analogy is with the point made in Part C of this note: a profit held in reserve is distributable despite

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[32] *Ibid.*, and see also *per Sheppard, J. supra* n. 7 at 167-168.
[33] Assuming that the total of the assets is still greater than the total of the liabilities. This assumption is made continually in the discussion below.
[34] *Supra* n. 8 at 624.
[35] *Supra* n. 7 at 167-168.
[36] [1924] 1 D.L.R. 361 at 362 (emphasis added).
[37] *Supra* n. 5 at 94.

losses suffered between creation of the reserve and the actual distribution of the profit so reserved. Like the situation envisaged by Hutley, J.A. it is an example of the principle that a profit is available for distribution unless it is otherwise irrevocably appropriated by the company.

Payable out of Profits

However, with respect it is submitted that the analysis of section 376 as presented by Hutley, J.A. cannot be regarded as an exclusive definition. His Honour held that section 376 laid down a pre-condition to the declaration of a valid dividend and no more. However, if it is held that the only question under section 376 and at general law is whether a profit was available at the moment of declaration, and everything thereafter is irrelevant, an absurd result may follow. A company, once having made a profit, could transfer it to a reserve. Henceforward that reserve may be used to justify the declaration of dividends.[38] Since section 376 is no longer relevant the company may pay the dividend like any other debt. As the reasoning under Part C demonstrates, the company is under no obligation to pay an ordinary debt out of reserves rather than out of capital. Therefore any loss resulting in the year may be charged against capital. At most the loss would only have to be charged proportionately against capital and the reserve. Then by an annual repetition of this procedure the bulk of the capital of the company may be dissipated in dividends.

The operation of the provisions of the Companies Act relating to accounting procedure[39] will not affect the above scheme if we accept that a declared dividend is an ordinary debt of the company. Yet it would seem an essential facet of the doctrine that a declaration and distribution of a dividend must affect the availability of profits. It is submitted that an answer to this dilemma is presented by Mahoney, J.A.:

> In relation to dividends, the principle that they shall be payable only out of available profits refers to the debiting of the amount of the dividend against an account showing a balance of available profits. Under the general law, the rule requires, at least normally, that when a dividend is declared and a right created in the shareholders against the company for payment of it, the appropriate profits account shall be debited with the amount of the dividend. Once this is done, then the requirements of the rule are satisfied.[40]

With respect it is submitted that this approach is to be preferred. Firstly, it produces a reply to the scheme presented above. Secondly, it is in accord with the decision of the House of Lords in *Chancery*

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[38] This assumes the reasoning and conclusions under Part C are correct.
[39] Section 162.
[40] *Supra* n. 8 at 643.

Lane Safe Deposit and Offices Co. Ltd. v. *I.R. Commrs.*[41] In that case the Court was called to construe similar terms in a taxation statute. The minority felt that "payable" means there was a notional right to elect how to pay, so the simple fact that a profit was available was enough. However, the majority decided that this notional right must be considered in the light of the way in which the debt actually was paid[42].

Mahoney, J.A. felt some hesitation in relation to the above requirements for two reasons. Firstly, his Honour did not want to make a final decision that no other accounting procedure would be acceptable. Secondly, his Honour wished to make it clear that nothing the company might do in its accounts could affect the accrued rights of the shareholders to a declared dividend.[43]

It is in relation to these points that it is suggested the declaration of the dividend has the effect of appropriating the profits. For the purposes of assessing divisible profits the court will treat the accounts as if a debit entry has been made against the profits to represent the declared dividend, whether this has been done or not. This would regard the declaration of the dividend as a *pro tanto* appropriation of the profits: "When declared, [the dividends] are set apart from corporate earnings and the relation of debtor and creditor is created."[44] However, the writer does not mean to suggest that this would create a proprietary interest in the profits for the benefit of the shareholders. It would simply mean that the profits involved were no longer available for distribution. Otherwise it would not affect the company's freedom in the way it keeps its accounts.

(C) On the facts of the case did the reserves represent profits available for distribution?

All judges on appeal concluded that it was not necessary to decide whether there were profits available at the time of the claim for satisfaction. However, Mahoney, J.A. concluded, as an alternative ground for his decision, that there were profits available. His Honour's reasoning is of particular significance since it also amounts to a consideration of the circumstances in which a company would be legally entitled to declare a dividend.

At the date of the claim for satisfaction it was accepted that there were two accounts under the heading of Revenue Reserves: the Retained Earnings Reserve (hereinafter called the RER) and the Unappropriated Profits/Losses Reserve (hereinafter called the UPLR). While there was a credit balance in the RER which *prima facie* was sufficient to support the dividend, there was a debit balance of $21

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41 [1966] A.C. 85.
42 *Id.* 115, 132 and 139.
43 *Supra* n. 8 at 643.
44 *In re Given's Estate* (1936) 185 A. 778 at 780.

million in the UPLR. Thus two independent questions had to be asked: was the income represented by the credit balance such as could support a dividend, and if so did it have to be set off against the debit balance in the UPLR? As his Honour observed the simple fact that two accounts exist under different names will not justify them being treated separately. The question must be resolved having regard to any functional differences which may have been the reason for the separate accounts.[45]

The RER

This account arose from transactions between the company and its subsidiaries. Mahoney, J.A. regarded the credit balance in this account at the time of the claim as arising from a purchase by the company of stock from a partnership and then re-sale to a new partnership where both partnerships were comprised of the company and various of its subsidiaries.[46] The company regarded this as a theoretical profit with no real existence which therefore should not be available for distribution. However, Mahoney, J.A. held that it was such a profit as to be legally divisible. His Honour relied on *Industrial Equity Ltd.* v. *Blackburn*[47] as authority that in construing the legal requirements in determining profits subsidiaries must be regarded as distinct entities. His Honour then distinguished between the legal requirements and the requirements of commercial prudence, without deciding whether commercial prudence could be applied at payment, should section 376 be held to apply at that point.

Such disregard for commercial prudence is reminiscent of certain remarks by Kay, L.J.[48] However, it is sometimes said to form the rationale of the various legal rules governing the availability of profits. Indeed, in the House of Lords it has been said that as the legislature had not seen fit to define such terms as "profits" and "capital" it was not for the courts to do so, but rather they should be left to businessmen and depend on the facts of the individual case.[49] However, while requirements of valuation and estimation have been left to the experts, the law relating to divisible profits is largely defined by fairly technical legal rules.[50] Further, these rules often allow profits to be divisible contrary to the dictates of commercial prudence. An example of this is the absence of any requirement to provide for depreciation of capital assets before dividing the revenue profits.[51]

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[45] *Supra* n. 8 at 633.

[46] This seems arguable, since in the year when the transactions concerned took place the revenue loss was greater than the amount held in reserve less the credit balance we are here considering.

[47] *Supra* n. 5.

[48] *Verner* v. *General and Commercial Investment Trust* [1894] 2 Ch. 239 at 268ff.

[49] *Dovey* v. *Cory* [1901] A.C. 477.

[50] For a formulation of these rules see *op. cit. supra* n. 4 at 797ff.

[51] *Lee* v. *Neuchatel Asphalte Co.* (1889) 41 Ch. D. 1.

The debit balance in UPLR

The account called the Profit and Loss Account of the company over the relevant period was made up as follows.[52] The company's net profit, including a provision for any amount lost on a revaluation of capital assets, was calculated. This was then added to the total of the UPLR and the RER to give an indication of the company's position on a continuous account. An amount was then transferred back to the RER which became the new balance in that account. The sum remaining in the Profit and Loss Account became the new UPLR.

Mahoney, J.A. referred to Dixon, J.'s judgment in the *Miller Anderson Case*[53] and equated the UPLR with the type of account there discussed:

> It has been used by the company to take into account succeeding revenue profits and losses, and as an account from which reserves, provisions and other accounts have drawn revenue profits, and into which such accounts have returned amounts which had their origin in revenue profits of various kinds.[54]

Clearly it was of considerable importance to his Honour that the company could have created a separate capital account to which it might have debited the loss from the valuation. If it had done so, then there would have been a credit balance in the UPLR over the period. Nevertheless the company had debited the loss to the Profit and Loss Account, and hence the UPLR. The actual nature and significance of this action was the point in issue, to which his Honour gave the following answer:

> . . . what for present purposes the company is to be seen to have done, is to have written only the credit of the latter account (the UPLR) against the capital loss, the revenue profits in the retained earnings reserve remaining, in the sense to which Dixon J. referred in the *Miller Anderson* case[55], as still available for dividend purposes. . . .[56]

Now it is settled law that capital losses which do not produce insolvency do not have to be considered in determining the divisible profits unless the company has already taken affirmative action to use those profits to replace the capital lost. Further the court will not be astute to find a capitalization of revenue profits. The creation of a reserve does not capitalize the funds so assigned.[57] In *Stapley* v.

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[52] It will be noted that this also contains a profit and loss appropriation account.

[53] *Federal Commissioner of Taxation* v. *Miller Anderson Ltd.* (1946) 73 C.L.R. 341 at 373-374.

[54] *Supra* n. 8 at 637.

[55] *Supra* n. 53.

[56] *Supra* n. 8 at 638.

[57] *Glenville Pastoral Co. Pty. Ltd. (In Liq.)* v. *Commissioner of Taxation* (1963) 109 C.L.R. 199 at 207.

Read[58] a company had written a provision for good will out of the capital account and replaced it with revenue profits. Then at a later date the company wished to distribute those profits and to write good will back into its accounts. In such circumstances Russell, J. declined to find a capitalization even though the accounts had been approved by the general meeting.[59] His Honour put some stress on the fact that had the accounts been kept in a different way the profits would still have been unquestionably available.[60]

Thus Mahoney, J.A's judgment is an application of two principles: that capital losses need not be provided for, and that profits accumulated in past years are divisible. It is the fact situation which is unusual. However, there is an added problem that the liability created by the dividend, added to the revenue loss in the year to 30th June, 1976, was greater than the amount held in the RER at the beginning of that year. Now, while it was accepted that accumulated profits held in reserve were available to pay dividends,[61] his Honour's judgment presumed that a current revenue loss is irrelevant, and does not have to be set off against the reserve before a dividend may be declared.

It is arguable that this assumption cannot be made since creditors may be unfairly prejudiced as may shareholders with a preferential right to return of their capital in the event of a winding up. Pennington stresses the unfairness to preference shareholders in claiming that a reserve cannot be divided without providing for a current loss,[62] and relies on the Northern Irish decision of *In Re John Fulton and Company*[63]. However, it is submitted that while that case is persuasive authority little weight need be attached to it since the point was decided without substantial consideration even though, as Pennington appreciates,[64] the reasoning in the English Court of Appeal mentioned below had been to the contrary. Further, the point was of little importance in the case since other breaches of directors' duties were patent. The American decision cited by Pennington in the argument has no relevance to the issue.[65]

This question is closely connected to the question whether a reserve must be considered when a company is applying for a reduction of capital. In *Re Hoare & Co. Ltd. and Reduced*[66] a reserve had been created and then trading losses occurred. On an application for a

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58 [1924] 2 Ch. 1.
59 *Id.* 5.
60 *Id.* 4.
61 *Supra* n. 57.
62 R. R. Pennington, *Company Law* (3rd ed. 1973) at 355.
63 [1932] N.I. 35 at 49.
64 *Op. cit. supra* n. 62 at 355.
65 *Lich* v. *United States Rubber Co.* (1941) 123 F.2d. 145 affirming 39 F. Supp. 675.
66 [1904] 2 Ch. 208.

reduction of the company's capital in view of these losses it was argued that the reserve should be applied to replace any lost capital first, but this argument was rejected. It is clear that the Court regarded the reserve as available for dividend purposes.[67]

Pennington relies on *Re Barrow Haematite Steel Co.*[68] as an authority to the contrary which should be preferred.[69] However, it is submitted that while the decision at first instance by Cozens-Hardy, J. in this case may be so interpreted, the Court of Appeal did not accept this interpretation as correct law, and Cozens-Hardy, L.J. (as he became) expressly disapproved of the interpretation which Pennington advocates.[70]

Thus it is submitted that the decision in *Re Hoare & Co. Ltd. and Reduced*[71] is substantial authority supporting the approach taken by Mahoney, J.A., however odd the result may seem. Further it does not seem unreasonable as a matter of principle to allow a company to delay a decision as to the distribution of an undoubtedly distributable profit. Finally, it is noted that the argument to the contrary seems to be based on the *quantum* theory of capital which would require the company to maintain funds equal to the whole paid up capital. Such a theory was rejected for the purposes of dividend law by the decision in *Verner* v. *General and Commercial Investment Trust*[72].

However, in *Re Hoare & Co. Ltd. and Reduced*[73] there was a limit placed on the availability of a reserve, which was not considered by Mahoney, J.A. In that case, as in the case before his Honour, the reserves were created by accounting entries and were not represented by distinct funds. The Court unanimously held that the reserves must share the loss proportionally with the capital account since they were represented by the same assets. It may be possible to distinguish the earlier case on the grounds that this limitation will only apply in relation to revenue losses and hence is not applicable to a situation involving capital losses. However, if the limitation does apply then the amount of the share capital would be relevant in ascertaining whether the company had reserves which could be distributed.

Finally it is noted that the doctrine of the maintenance of capital seems to be even further confined by the decision in this case. However, it is hoped that the argument above will demonstrate that the result flowed logically from the rules which had already been laid down, and that a decision in favour of the company would also have produced undesirable results. It may be that the creditor needs more

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[67] *Id.* 217.
[68] [1900] 2 Ch. 846; [1901] 2 Ch. 746.
[69] *Op. cit. supra* n. 62 at 172.
[70] *Supra* n. 66 at 219.
[71] *Id.*
[72] *Supra* n. 48.
[73] *Supra* n. 66.

protection than just the law of insolvency, but it is important to remember that the doctrine also has a function in defining the rights of the various classes of shareholders.

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