DIVIDENDS AND THE PROPER DISCLOSURE OF PROFITS

INDUSTRIAL EQUITY LTD. & ORS. v. *BLACKBURN & ORS.*[1]

BLACKBURN & ORS. v. *INDUSTRIAL EQUITY LTD. & ORS.*[2]

When Industrial Equity Ltd. purported to make a special distribution of assets, its accounts did not show profits sufficient to justify payment. A shareholder challenged the validity of this distribution. At first instance and on appeal, the company failed to justify its directors' resolution, despite the variety and novelty of their submissions. The judgments of the courts clarify the requirements in company law as to the payment of dividends, especially when those dividends are payable from profits revealed by the revaluation of capital assets.

Over half of the issued share capital of Industrial Equity was held by Graziers' Life Assurance Co., which shared three directors of the company. At a board of directors meeting on the 30th October, 1975, it was resolved that, in addition to the company's 15% ordinary dividend, a special distribution of one share in Minerva Centre Ltd. (a subsidiary of the company) be made for every four shares held in Industrial Equity. One condition of this resolution was that the distribution discriminate between shareholders — Graziers' Life Assurance was to receive the value of this distribution in cash and not by way of shares. That day the annual general meeting adopted a motion approving the declaration of dividends on this basis.

In the Profit and Loss Account of the company there was a substantial operating loss. An "extraordinary item", adjusting the valuation of some shares held by the company, was credited to the accounts, so that a net profit was revealed. When unappropriated profits from previous years were added, the accounts yielded a sum of $313,500 from which dividends could be declared. The cash dividend of 15% required a sum in excess of $250,000. Thus, the accounts of the company did not show a sum available from profits and reserves which could satisfy the liability of $647,500 for the special distribution.

The plaintiff shareholders challenged the special distribution on two grounds: (1) that it was discriminatory as regards the provision for the payment in cash to the major shareholder: the articles, it was argued,

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[1] (High Court) [1977] C.C.H. A.C.L.C. 40-370.
[2] (N.S.W. Court of Appeal) [1977] C.C.H. A.C.L.C. 40-324.

provided no authority for this differentiation between shareholders in the manner of payment; (2) that it involved the payment of a dividend otherwise than from the profits, in contravention of the Uniform Companies Act (U.C.A.), s. 376 (1).

In order to sustain their distribution, the defendants submitted on appeal that:

(1) a dividend could discriminate between shareholders, since the board had the power to settle difficulties in the payment of dividends;

(2) the profits existing in the subsidiary companies of the Industrial Equity group were available for distribution by Industrial Equity, because the U.C.A. requires the presentation of group accounts;

(3) the company could sustain its distribution as an interim dividend, because, it was argued, the board held a residual power to pay interim dividends;

(4) a revaluation could produce a sum available for distribution, although no such surplus had been revealed at the time of payment.

In rejecting these submissions, the High Court and the New South Wales Court of Appeal elucidated the law with respect to these four aspects of dividends. Although the defendants amended their submissions before the High Court in certain respects, points of interest arose in all four areas.

The Law

(1) The Discriminatory Character of the Dividend

Article 137 of the company's articles of association provided:

> For the purpose of giving effect to any resolution under the three last preceding articles the directors may settle any difficulty which may arise in regard to the distribution as they think expedient and in particular may issue fractional certificates and may fix the value for distribution of any specific assets and may determine that cash payments shall be made to any members upon the footing of the value so fixed or that fractions of less value than one dollar may be disregarded in order to adjust the rights of all parties . . . .

In the High Court, Mason, J.[3] found upon interpretation of the article that the essential condition of the power conferred on the board was a "difficulty to be settled". Before the directors could discriminate between shareholders they must assign a reason for their action. This reason must relate to a difficulty inherent in or arising in connection with the proposed distribution itself. The defendants had argued that the articles conferred a discretion sufficiently wide to justify the payment in cash to Graziers' Life Assurance. Mason, J. held that the discretion under the article was limited to those difficulties contemplated within its own terms, such as the entitlement to a fraction of a share.

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[3] *Supra* n. 1, Aicken, Murphy, Stephen, JJ. concurring.

Because the discriminatory nature of the distribution rendered the resolution completely invalid, either as an interim dividend or as a final dividend,[4] it seems the courts would not sever the offending conditions in a declaration in which the board exceeds this narrowly defined discretion.

(2) The Profits of Subsidiary Companies

The company and board argued that as it was required by U.C.A. s. 162 to present group profit and loss accounts, profits evident in these accounts were available for distribution by the parent company. The wholly-owned subsidiaries of Industrial Equity showed unappropriated profits of $5,000,000 in their accounts. This accumulated sum, the company submitted to the High Court, was effectively the profit of the holding company. If the subsidiaries had declared a dividend, then the holding company would have undoubtedly been entitled to show this debt as a current asset in their own accounts. But the company was asserting that the group accounts alone established profits and so fulfilled the requirements of U.C.A. s. 376(1).

It is well established in law that the company has a separate legal entity — *Salomon* v. *Salomon and Co. Ltd.*[5] However, it has been argued that the sections of the U.C.A. which stipulate certain requirements for group accounts go some way towards treating all companies within a group as part of the same entity. Gower[6] saw a tendency "towards recognizing the real business unit of interlocked companies, rather than the arbitrary legal unit of a single company . . . indeed, it may fairly be said that all that the Companies Acts do is to afford some measure of protection against the rigid consequences of the rule in *Salomon's Case*, to shareholders actual and potential". This argument was rejected by Mason, J. Although s. 376(1) does not explicitly identify the source of "profits" to which it refers, Mason, J. understood it to refer to the profits of the company declaring the dividend.[7] His Honour relied upon the fact that, immediately upon the declaration of a dividend, a debt owing by the company to each shareholder "springs into existence" — *Re Severn and Wye and Severn Bridge Railway Co.*[8] Since the shareholders become creditors of the company at that moment, they can have only the right of any creditor to look to the single company entity for payment of his debt, and not to the group. The requirement of the U.C.A. serves only to provide information as to the group and to that extent offer some small protection to a shareholder. This requirement remains additional to, and not in substitution for, the obligation on the directors to present the company's accounts so as to give a true and fair view of its affairs.

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[4] *Id.* at 29, 638.
[5] [1897] A.C. 22.
[6] L. C. B. Gower, *Modern Company Law* (3rd ed. 1969) p. 199.
[7] *Supra* n. 1 at 29, 640.
[8] [1896] 1 Ch. 559.

Section 376 which requires that dividends shall be payable from profits is to be understood as stipulating that profits of an amount necessary to satisfy the debt created by the declaration of a dividend are in existence in the company at the date of the 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 — because it is the declaration that creates the right in the shareholder and it is the declaration that reflects the consideration by the directors or shareholders of the accounts and profit situation of the company.[9]

Since group profits are merely anticipated as income to the parent company, a company cannot declare a dividend against this possibility. As at the date of the resolution, 30th October, 1975, any receipt of profits in the subsidiary must be considered as an element of the company's profit in the succeeding year.

Mason, J. speculated that the prohibition may extend to the payment of a dividend when profits are not in existence at the time of payment though there was a profit at the time of declaration. This second question in regard to section 376 is of equal importance to every company board and is currently at issue in *Marra Developments Ltd.* v. *B. W. Rofe Pty. Ltd.*[10] The New South Wales Court of Appeal, by reference to Mason, J.'s distinction between "payable" and "paid", decided that the prohibition in section 376(1) did not extend to the time of payment. As the High Court has granted leave to appeal from this decision, final clarification of this issue must await that appeal.

(3) Whether the Defendants Resolved to Pay an Interim Dividend

The defendants argued that any insufficiency in the accounts for the year ended 30th June, 1975, did not invalidate the special distribution resolved on the 30th October, 1975. Their interesting argument was that the resolution had in essence been two-fold — firstly the declaration of a final dividend for the year ended 30th June, 1975 and secondly the resolution to pay an interim dividend for the subsequent year. That is, it was submitted, that the special distribution could be justified by profits existing in the accounts for the year ended 30th June, 1976.

Under Article 134, the directors when declaring a dividend may resolve that such dividend be paid by the distribution of specific assets. Article 128 referred to the directors the power to declare a dividend and Article 131, in the same form as article 82 of Table A, 4th Schedule, U.C.A., referred to interim dividends: "The directors may from time to time pay to the members such interim dividends as appear to the directors to be justified by the profits of the company". In effect, the directors

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[9] *Supra* n. 1 at 29, 641 *per* Mason, J.
[10] [1977] 51 A.L.J.R. A.C.L.C. 40-375 *per* Mahoney, J., Hutley, J.A., Moffit, P.

argued that the powers under Articles 128 and 131 both related to the power conferred in Article 134. Then, once they had formed an opinion to pay an interim dividend, they could make this payment in the manner of a special distribution of specific assets, under Article 134.

It should be remembered that to pay an interim dividend is a separate power of the board to the declaration of a final dividend. If a final dividend is declared without any stipulation as to the date of payment, the declaration creates an immediate debt. Further, if a final dividend is declared but expressed payable at a future date, a shareholder has a right to enforce payment when the date arrives.[11] In the case of an interim dividend, however, it is open to the directors at any time before payment to review their decision and revoke their authorization to pay.[12] Unlike the final dividend, no debt is created by the resolution of the board.

The courts would not accept the submission that the directors had exercised a power to pay an interim dividend for three reasons.

(a) As a question of fact, only one resolution had been passed, without any distinction being made between final and interim dividends. Needham, J., at first instance, and the judges on appeal held the directors never to have intended to pay two separate dividends.

(b) Hutley, J.A. offered a distinct ground for rejecting the submission. If the resolution to pay an interim dividend is based on an estimate formed by the directors, His Honour reasoned, then they cannot later argue that they "declared" an interim dividend without applying their minds to the question. It seems there is no residual power to make an interim dividend in the event of a final dividend being defective.[13]

(c) In that the company sought to make a distribution under Article 134 when paying an interim dividend, their efforts must be illegal on construction of Article 134. In the High Court, Mason, J. relied upon the distinction between the two dividends. As the power under Article 134 is expressed to be given to the directors "when declaring a dividend" it must be taken to refer to the power over final dividends, not to the power to "pay . . . an interim dividend" under Article 131.[14] So, the power under Article 134 would permit the distribution of specific assets only when the board could pay a final dividend and could justify it in the accounts for the year ended 30th June, 1975. In the New South Wales Court of Appeal, Glass, J.A. had dismissed the submission on the same construction of the article.

An interesting and separate question is whether the company could have made a cash payment, and justified it as an interim dividend, relying solely on Article 131. Hutley, J.A. conceded that an interim dividend could be resolved in these circumstances:

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[11] *Potel* v. *I.R.C.* [1971] 2 All E.R. 504.

[12] *Lagunas Nitrate Co. Ltd.* v. *Schroeder & Ors.* 85 L.T. 22.

[13] *Supra* n. 2 at 29, 386.

[14] *Supra* n. 1 at 29, 637.

> It is, therefore, theoretically proper for there to be a declaration of an interim dividend which may in fact require revaluation of fixed assets to provide the fund to justify it in the annual accounts, even though the revaluation has not been carried out. However objectionable on any sound financial principles this may be, I cannot see any legal answer to this part of the argument of counsel for the appellants.[15]

This opinion was shared by Needham, J at first instance, who commented:

> It may be that directors, pending a revaluation, could pay an interim dividend on account of the final distribution of profits and take the chance of the company being in a position, at the end of the financial year, to cover the interim dividend . . .[16]

If these *obiter dicta* correctly express the law, then they represent an extension of the practice of declaring dividends from a revaluation of capital assets, which the courts have previously accepted.[17] Two points of enquiry are necessary — the time of resolution and the time of payment.

It seems logical that the directors can resolve to pay an interim dividend without having effected or contemplated any revaluation of assets which might justify it. The resolution does not operate as a declaration that a debt exists or even that payment will be made in respect of any period of time — *Re Jowitt, Jowitt & Keeling*[18] — so that the directors need not undertake any such revaluation.

Is it also permissible for the directors to make payment before the actual revaluation which will justify it has taken place? Needham, J. would permit this possibility. Hutley, J.A. is less clear, though. He speaks of "the declaration of an interim dividend" requiring revaluation to provide the fund to satisfy it. There is strictly no declaration of an interim dividend, only a resolution to pay; but his Honour would not seem to require that revaluation precede either of these events. As an interim dividend paid during an accounting period must be accounted for as a component of the final dividend for that year, it would seem appropriate to test its validity at the end of the accounting period. Hutley, J.A. considered it unnecessary for accounts to be prepared before paying the interim dividend and cited the *dictum* of Lord Alverstone, C.J. in *Lucas* v. *Fitzgerald*:[19]

> The declaration of interim dividends depends much more upon estimates and opinions than the declaration of a final dividend which is made upon the information contained in a formal balance sheet.

Although this *dictum* supports the view that accounts need not be prepared, is the opinion of the directors that a revaluation will produce

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[15] *Supra* n. 2 at 29, 386.
[16] [1974-1978] 2 A.C.L.R. 8 at 14.
[17] In *Dimbula Valley (Ceylon) Tea* v. *Laurie* [1961] 1 Ch. 353.
[18] [1922] 2 Ch. 442.
[19] 20 T.L.R. 16 at 18, *per* Hutley, J.A., *supra* n. 2 at 29, 386.

a surplus sufficient of itself to justify an interim dividend when no revaluation has occurred?

Palmer's Company Precedents[20] also cites Lord Alverstone to the effect that formal accounts are unnecessary. But *Palmer* refers to it in qualification of a more generalized statement: "[b]efore the declaration of an interim dividend, the directors must satisfy themselves that there are profits to divide", for which *Palmer* cites as authority *Towers* v. *African Tug Co.*[21] But this decision seems to decide only that it would be *ultra vires* the board's power to pay an interim dividend when the directors knew that a current profit was insufficient to restore a credit balance to the company's accounts. Positive knowledge that a dividend cannot be justified is the converse situation to that where a possible surplus on capital account may be revealed on revaluation. The question with respect to this situation could be formulated in two alternate ways: whether profits from which an interim dividend is paid are profits which the directors anticipate would have been disclosed if accounts were prepared at the time of payment, or whether they are profits which the directors anticipate would be disclosed when the final accounts are produced. While *Palmer* may prefer the former formulation, the latter was favoured by Hutley, J.A. in *Marra Developments Ltd.* v. *B. W. Rofe Pty. Ltd.*[22] where he held: "The profits out of which it is to be calculated [are] profits which the directors believe will be disclosed in anticipated accounts". In his Honour's opinion, s. 376(1) would be breached if the profits later disclosed in such accounts could not have enabled the directors to form a genuine opinion that profits will actually exist.

In the High Court in *Industrial Equity Ltd.* v. *Blackburn*,[23] Jacobs, J. adverted to this problem of when the payment is to be tested:

> I am satisfied that the distribution could not be regarded as an interim dividend in respect of the financial year ended 30th June, 1976 . . . Further, I am not satisfied that it would make any difference even if it were. 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 either by accounting periods or the accounting system.[24]

With respect, since profits can only be revealed in an "accounting system", this latter remark seems curious. It may be that his Honour intended to impose a duty on directors to enquire as to profits at the time of payment. Jacobs, J. continued: "The question is whether there were profits at the relevant time which I shall take to be the time of payment and the making of the distribution".[25]

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[20] *Palmer's Company Precedents* (17th ed. by K. W. Mackinnon and R. Buchanan-Dunlop, 1956) p. 601.
[21] [1904] 1 Ch. 558.
[22] *Supra* n. 10 at 29, 685.
[23] *Supra* n. 1.
[24] *Id.* at 29, 642.
[25] *Ibid.*

In contrast to Hutley, J.A., who only requires an opinion as to profits existing, Jacobs, J. seemingly requires directors to know what profits will exist. A revaluation would necessarily precede payment. With respect to Jacobs, J., it may be that this duty is unnecessary, in that profits may well exist even at the time of payment and yet the final accounts may produce a loss for the year. Directors will still need to test the validity of dividend payments against final accounts. To require more than an honest opinion appears unnecessary and commercially inhibitive.

If, however, it is within the power of the board to pay an interim dividend in the mere anticipation of a surplus, which a revaluation might reveal, this could be an important power to the board in a takeover situation.

The 1975 Corporations and Securities Industries Bill provided, in its takeover provisions, requirements that a target corporation must observe. Clause 238 provided that a corporation shall not cause or permit a public announcement to be made stating that the market value of any of its assets differs from the book value of that asset unless a statement as to the revaluation is lodged with the Corporations and Exchanges Commission, signed by a person qualified to value the assets and stating the amount of their value and the basis of his opinion. This provision is probably to be included in the revision of Part VI of the U.C.A., expected before the end of 1978.

But the provision does not appear to prevent the board from paying an interim dividend on the basis of a proposed revaluation, without a public statement referring to the revaluation. Payment of an interim dividend may deprive the target company of liquid assets and render it unattractive to the bidder.

(4) The Revaluation of Capital Assets and its Disclosure

The defendants argued that the company was not in breach of U.C.A. s. 376 because profits were present in the company, in that certain assets of the company were undervalued. They submitted that:

(a) a surplus appearing on revaluation is divisible in the form of a dividend (relying on *Dimbula Valley (Ceylon) Tea Co. Ltd.* v. *Laurie*);[26]

(b) the revaluation of company assets would produce a surplus; evidence of the share value of subsidiaries and the amount of unappropriated profits was produced;

(c) the potential surplus was distributable because it created a profit present at the time of declaration of the special distribution.

At first instance, Needham, J. would not accept this argument. If the directors submit to a general meeting the audited accounts as a true and fair view of the company's business, they cannot later claim that

[26] [1961] 1 Ch. 353.

assets would produce a surplus on revaluation.

In the Court of Appeal, Glass, J.A. also rejected these "heroic" submissions. Before distribution can occur, without a breach of U.C.A. s. 376, the revaluation must first disclose to the company the surplus which can be distributed by the final dividend. Glass, J.A. considered the conflict between the Scottish Court of Session decision in *Exp Westburn Sugar Refineries Ltd.*[27] and Buckley, J.'s decision in *Dimbula Valley (Ceylon) Tea Co. Ltd.* v. *Laurie.*[28] His Honour adopted the *ratio decidendi* of Buckley, J.'s judgment acknowledging the legality of such a distribution but rejecting the company's particular submissions as not complying with the Ninth Schedule of the U.C.A.:

> It has, I think, long been the general view of the law in this country (though not established by judicial authority) that, if the surplus on capital account results from a valuation made in good faith by competent valuers, and is not likely to be liable to short-term fluctuations, it may properly be capitalised: see *I.R.C.* v. *Thornton, Kelley & Co. Ltd.* (1957) 1 W.I.R. 482. For myself, I can see no reason why, if the valuation is not open to criticism, this should not be so, or even why, in any case in which the regulations of the company permit the distribution by way of dividend of profit on capital account, a surplus so ascertained should not be distributed in that manner . . . I do not say that in many cases such a course of action would be a wise commercial practice, but for myself I see no ground for saying that it is illegal.[29]

By the Ninth Schedule of the U.C.A., profits arising on revaluation must be brought into the accounts with a statement as to their incorporation in the determination of profit. Both revaluation and appreciation in accordance with the Act are necessary before a fund is available for distribution.

Glass, J.A. does consider the wisdom of this practice:

> It will be seen that great caution is enjoined before directors are entitled to transfer a surplus resulting from the appreciation of assets to a capital reserve for payment of bonus shares. Even greater circumspection is required before they may transfer it to the profit and loss account and pay dividends from the fund thereby created.[30]

Professor R. Baxt[31] has expressed an opinion that Glass, J.A. is proposing an "apparent requirement" of outsider valuation. However, both Buckley, J. and Glass, J.A. seem to be *recommending* and *not requiring* these careful procedures. While directors are to discharge their duty to present a true and fair view of the company, there may be occa-

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[27] [1960] T.R. 105.
[28] *Supra* n. 26.
[29] *Supra* n. 2 at 29, 389 *per* Glass, J.A., following Buckley, J. in *Dimbula Valley (Ceylon) Tea Co. Ltd.* v. *Laurie, supra* n. 26 at 373.
[30] *Supra* n. 2 at 29, 390.
[31] R. Baxt, Commercial Law Note, 51 *A.L.J.* 662.

sions when their opinion as to the value of business assets, unsupported by outside revaluation, will be sufficient

Although Glass, J.A. has demanded compliance with the statutory statements of appropriation to revenue accounts, it remains uncertain whether the requirements of the Ninth Schedule have affected the need for a complete revaluation of all assets before a surplus is made available for distribution—*Australasian Oil Exploration Ltd.* v. *Lachberg & Ors.*[32]

To the extent that the doctrine of *Dimbula Valley*[33] represents a further diminution in importance of the doctrine of maintenance of capital, it is the unplanned brother to the statutory mechanisms of capital reduction under U.C.A. s. 64, and the issue of bonuses. The Jenkins Committee[34] reviewed these procedures. It recommended, in effect, a statutory reversal of the doctrine in *Dimbula Valley (Ceylon) Tea Co. Ltd.* v. *Laurie.*[35] In their view, profit is normally established at the time at which it is realised by the transfer of ownership or completion of services rendered, and only realised profits could be properly regarded as distributable. The Committee considered that capital reserves should be available only to constitute a reserve for the allotment of bonus shares.

Despite these criticisms, the legality of these procedures has been completely accepted. In the High Court, Jacobs, J.[36] referred to *Dimbula Valley (Ceylon) Tea Co. Ltd.*,[37] and approved the amendments to the defendants' submissions which accepted the decision. In *Marra Developments Ltd.* v. *Rofe Pty. Ltd.*,[38] the New South Wales Court of Appeal construed this remark as constituting authority for the doctrine.

This acceptance is modified by the requirement that the company's transfer of capital profits to revenue accounts be accompanied by full adherance to the Ninth Schedule. Proper disclosure seems a necessary condition to the legality of any dividend declared on profits accruing through a revaluation of assets.

Conclusion

Although the law of dividends has not generated much litigation, as directors will attempt to exercise great caution before incurring a debt on behalf of the company which may be illegal, this Industrial Equity litigation is important for its clarification of some of the issues. The legality of distributing by way of a dividend a surplus revealed by revaluation appears now to be established, though it may be a commercially unwise course of action.

The possibility of the payment of an interim dividend on a com-

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[32] (1958) 101 C.L.R. 119.
[33] *Supra* n. 26.
[34] *Report of the Company Law Committee* (Cmnd. 1749, 1962) paras. 336-339.
[35] *Supra* n. 26.
[36] *Supra* n. 1 at 29, 642.
[37] *Supra* n. 26.
[38] *Supra* n. 10.

pleted revaluation is an extension to this field of law, and important in that the requirements appropriate to the final dividends are avoided.

The court will not, though, accept reliance upon an incomplete appropriation of unrealised profits in order to justify a final dividend. The profits of subsidiary companies, even when wholly owned, cannot be relied upon when they remain in the subsidiary.

If directors adhere to requirements of disclosure and the above rules, the wisdom of making dividend payments is a matter for them to decide, and is not a matter of law. The flexibility granted to the company by this judicial acceptance may have important consequences in some boardrooms.

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