THE LEGAL RULES ON THE PAYMENT OF DIVIDENDS

PRELIMINARY LEGAL CONFIRMATIONS

The provisions of sections 51 and 52 of the *Companies Act* dealing with the payment of dividends and the specific principles of corporate law and corporate capital as enunciated in case law are applicable in respect of the legal analysis referenced on the issues referenced in this memorandum.

The above confirmation is based on our legal analysis of the relevant statutes, specifically (a) the provisions of the *Companies Act* (and in particular sections 15, 16 and 17, which deal with the right to distributions, the payment of contributions, and the liability of members).

The statutory solvency provisions reflect an acknowledgement of the common law doctrine on corporate maintenance, traditionally viewed as a co-incident of the privilege for limited liability. The common law doctrine on corporate maintenance is intended to ensure the protection of creditors by assuring that (as a matter of public policy), there is no diminution or erosion of the capital base by returning capital to shareholders. This judicial articulation has given rise to specific judicial rules as to the circumstances in which payments of dividends are permissible.[1]

The statutory solvency provisions in the *Companies Act* however subsume or overrule the specific judicially defined rules in respect of the payment of dividends.[2]

The onus and obligation on the directors is for cash and financial management which is appropriate to the needs of the specific corporate entity without reference to pre-defined judicial rules which inaccurately reflect investor expectation.[3] In this context the rules as to payment of dividends, are to be viewed as a whole - that is a series of specific statutory rules intended to ensure that the specific corporate entity has cash and financial resources adequate to its specific needs. This is to be determined by the directors **at the relevant specific point in time**.

PROHIBITED DIVIDENDS AND PAYMENT OF DIVIDENDS

Prohibited Dividends

Under section 51(b) of the *Companies Act*, a company is permitted to make a payment of dividends in any financial year in circumstances where the directors have reasonable

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1 Bond v Barrow Haemetite Steel Co. (1903) 1 Ch. 353 – "*dividends must not be paid out of capital… dividends must be paid out of profits*."

2 The abolition of the common-law rules in the statutory prescription as to payment of dividends, does not necessarily imply that the application of the judicial rules will necessarily lead to a different result; the statutory formula "replaces" the specific legal rules as questions of law, and these now become factual criteria in the determination of compliance with the statutory standard.

3 per Professor Gower – "what interests creditors is not whether … (capital) remains intact but whether the net worth of the business is maintained …."

grounds for believing that it satisfies the statutory test of solvency, namely, that after the payment of the dividends: [4]

(a) a company is able to pay its liabilities as these fall due, that is it has the cash and financial resources to meet its current payment obligations; and

(b) the realisable value of the assets of a company exceed the aggregate of stated capital and liabilities, that is it remains solvent as a going concern.[5]

The statutory test of solvency, and specifically the solvency standard under section 51(b) of the *Companies Act*, is independent of the financial statement reports. The audited financial statements are used as a *bona fide* basis for the determination of matters relevant to the calculation (specifically the liabilities and stated capital), but the accounting entry for assets is not necessarily relevant, and as such the audited financial statements do not determine whether dividends are payable. Specifically the statutory solvency rule properly applied will permit the payment of dividends in the appropriate circumstances, including:

(a) the payment of dividends out of profits of a current financial year, notwithstanding accumulated losses in previous financial periods; and

(b) the validation of payment of dividends out of profits of a current financial year, notwithstanding the revaluation or accumulated loss thereafter for that financial period; and

(c) dividends may be paid notwithstanding a reduction in the valuation of an asset in the audited financial records in accordance with generally accepted accounting principles, if it is the *bona fide* reasonable belief of the directors that the realisable value of the assets is greater than that as stated in the audited financial records in accordance with generally accepted accounting principles.

Judicial interpretations specifically as to the "realisable value" of the assets are helpful to the extent only that they emphasise that the term is not a legal term of art. Successive decisions have relied upon the plain and ordinary meaning as judges have relied on the dictionary definition of the term. As explained the term involves a final and completed change of identity into distributable or usable cash. The notion involves at least the concept of sale between a willing buyer and a willing seller; and as such the depreciated value of a fixed asset must be taken into account in the determination of the realisable value.

Payment of Dividends – Unrealised Profits

Under section 52(2) of the *Companies Act*, a company is not permitted to pay a dividend out of unrealised profits. There are alternative academic and judicial interpretations as to this statutory provision.

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[4] As noted by Welling in respect of these solvency tests – "*No one is being asked to actually compute the (amorphous) realisable value of the company's assets before declaring a dividend. The section does not invalidate a dividend that was paid when the formula is in retrospect unbalanced. The section focuses on a … measurable (legal) test, the reasonable grounds for belief that either of the two financial tests will be violated*."

[5] As noted by Welling – these are two independent tests. The first requires a prediction of how the accounts receivable and accounts payable will look in the next few weeks immediately following the payment of dividend. The second is a good faith value determination of assets (which has no accounting accuracy) measured against specific items which are identified in the financial statements.

One view of this statutory provision is that it affirms a judicially developed legal rule as to payment of dividends, namely that losses from prior financial periods are not required to be made up before a dividend could be paid. Dividends could be paid to the extent there are profits in the current financial period.

An alternative interpretation (and the current prevailing academic opinion) is that section 51 of the *Companies Act* in fact overrules the judicial rules, and that section 52(2) of the *Companies Act*, creates a separate legal standard in that it prohibits the permissibility under the judicially defined rules of taking unrealised gains into the calculation of realisable value. On this thesis an unrealised gain is not an "exception" to the meaning of the term "unrealised profits" but is part of the understanding of that term within the *Companies Act*.

It is beyond the scope of this memorandum to consider the relative merits of the different interpretations. It is sufficient to note that on either thesis there is an acknowledged limitation on the payment of dividends; and that in conjunction with section 51 of the *Companies Act*, is an integral and conjunctive part of the permissibility and methodology for the distribution of cash and other property to shareholders.