REVALUATION RESERVES AND PRE-ACQUISITION PROFITS: SHOULD THEY BE DISTRIBUTABLE TO COMPANY SHAREHOLDERS?

Introduction

In 1882 directors who recommended a dividend when there was no proper fund out of which to make payment were held personally liable for such payment. *Re Exchange Banking Company (Flitcroft's case)*.[1] At least since this time[2] the problem of when a dividend may be paid has vexed both the legal and accountancy professions. The courts, too, have been divided in their approach. On the one hand they have tried to provide protection for creditors—

> It is a fundamental principle of company law that the whole of the company's capital, unless diminished by expenditure on its objects, must remain available for discharge of its liabilities[3] or in the words of Lord Herschell in *Trevor* v. *Whitworth*,[4] [Creditors] have a right to rely . . . on the capital being undiminished by . . . the return of any part of it to the shareholders.

On the other hand the courts have been reluctant to interfere with the bona fide decisions of men of business as to what are profits—

> There is nothing at all in the Acts about how dividends are to be paid, nor how profits are to be reckoned, all that is left, and very judiciously and properly left, to the commercial world. It is not a subject for an Act of Parliament to say how accounts are to be kept; what is to be put into a capital account, what into an income account is left to men of business.[5]

Again Lord Macnaghten in *Dovey* v. *Cory*[6] said in discussing when dividends might be paid:

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1. (1882) 21 Ch.D. 519, C.A. The directors' liability is without prejudice to their right to be indemnified by shareholders or creditors privy to the payment of capital: *Re Alexander Palace Co.* (1882) 21 Ch.D. 149 and *Moxham* v. *Grant* [1900] 1 Q.B. 88, C.A. as to the principles which govern a director's liability see *Dovey* v. *Cory* [1901] A.C. 477, 492 per Lord Davey and also *Leed's Estate* v. *Shepherd* (1887) 36 Ch.D. 787 and *Prefontaine* v. *Grenier* [1907] A.C. 101, J.C.
2. This decision was foreshadowed in dicta in *In re Merchantile Trading Company (Stringers'Case)* (1869) 4 Ch. App. Cas 475, 487 per Sir C.J. Selwyn L.J.
3. *Jenkins* v. *Harbour View Flats Ltd* [1966] N.Z.L.R. 1, 22, C.A.
4. (1887) 12 App. Cas. 409, 415.
5. *Lee* v. *Neuchatel Asphalt Co.* (1889) 41 Ch.D. 1, 21, C.A.
6. [1901] A.C. 477, 488.

And I do not think it desirable for any tribunal to do that which Parliament has abstained from doing—that is, to formulate precise rules for the guidance or embarrassment of business men in conduct of business affairs.

This principle of non-interference was followed in a series of cases[7] although Yamey[8] points out nearly all these decisions were strongly criticised in the pages of the contemporary *Accountant* and indeed the decision in the *Ammonia Soda Co.* case was given despite the evidence of two eminent accountants that what had been done by the directors "was contrary to all principles of commercial accountancy.[9] The auditors of the company in that case, had, however, made a special note drawing attention to what had been done and they certified the balance sheet subject to this without actually stating that it was wrong.

As every dividend payment is sanctioned by a company's board of directors, which, by hypothesis, consists of men of business every dividend, unless prompted by an improper motive, can on the basis of this decision, be regarded as proper from a business point of view.

The extent to which creditor protection had been subjugated to the court's reluctance to interfere is illustrated by the case of *Lawrence* v. *West Somerset Mineral Railway Company*[10] where a company leased a railway to another concern, the lease expiring in 1919. The rent was sufficient to pay bondholders and to make a dividend payment. The railway fell into disuse and in 1918 the bondholders sought an injunction to restrain payment of a dividend on the grounds that there would be insufficient assets to repay the debenture when it fell due in 1919. The injunction was refused following the principle in *Verner and Ammonia Soda Co.* that losses in capital need not be made up from current income.

Since these cases were decided however, Parliament has laid down how accounts are to be kept. By sections 152 and 153 of the Companies Act 1955 the directors of every company are required to lay before the company each year a profit and loss account for the year and a balance sheet as at the date to which the profit and loss account is made up. Such accounts must give "a true and fair view of the profit and loss of the company for the financial year" and "of the state of affairs of the company as at the end of its financial year.",[11] and subject to an exception for some private companies[12] they must be audited. In addition

7. These cases include *Verner* v. *General and Commercial Investment Trust* [1894] 2 Ch. 239, C.A.; *Re Kingston Cotton Mill Co.* (No. 2) [1896] 1 Ch. 331, [1896] 2 Ch. 279, C.A. and *Ammonia Soda Co.* v. *Chamberlain* [1918] 1 Ch. 266, C.A.
8. Yamey, "Aspects of the Law Relating to Company Dividends" (1941) 4 M.L.R. 273.
9. *Ammonia Soda Co.* v. *Chamberlain* supra, n. 7 at p. 275.
10. [1918] 2 Ch. 250.
11. Section 153 (1).
12. Section 354 as amended by s. 29 of the Companies Amendment Act 1960.

the accounts must be drawn up and disclose the information required by the Eighth Schedule to the Act.

Also, it may be fraudulent for the directors to pay dividends if the result is that the company is unable to pay its debts as they fall due. For instance Warrington L.J. in *Ammonia Soda Co.* v. *Chamberlain* qualified his decision that past losses need not be made up by adding

> I am, of course, far from saying that in all such cases dividends can properly be paid without making good the previous loss; the nature of the business and the amount of the loss may be such that no honest and reasonable man of business would think of paying dividends without providing for it. In such a case I apprehend the Court would take the view that a payment which no honest and reasonable man of business would think it right to make could not properly be made by directors.[13]

It may now be that the courts will be more prepared to intervene and designate a dividend as improper. This may be especially so if the interests of creditors are threatened and if the declaration of the dividend is contrary to sound accounting principles. Over the last fifty years the accountancy profession has grown considerably in size and stature. Company directors have consulted more frequently and taken more notice of chartered accountants and the profession itself is better organised and more concerned with its professional standing.[14]

In any event it has long been held that each case must be decided on its own particular facts and merits. Lord Halsbury L.C. in dealing with the dividend question said

> I doubt very much whether such questions can ever be treated in the abstract at all. The mode and manner in which a business is carried on, and what is usual or the reverse, may have considerable influence in determining the question of what may be treated as profits and what as capital.[15]

The same point was made in another contemporary decision

> the real question for determination, therefore, is whether there are profits available for distribution and this to be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses.[16]

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13. Supra, n. 7 at p. 292. See also *Peter Buchanan Ltd.* v. *McVey* (1950) reported at [1955] A.C. 516 n, 521, 522.
14. Although this has not prevented the declaration of dividends when capital has been clearly lost as in the cases of Reid Murray Ltd, Rolls Razor Ltd and Neon Signs Ltd.
15. *Dovey* v. *Cory* [1901] A.C. 477, 486.
16. *Bond* v. *Barrow Haematite Steel Co.* [1902] 1 Ch. 353, 365 per Farwell J.

It is against this background that it is now proposed to consider the legality of declaring dividends from reserves which arise on the revaluation of fixed assets and from dividends received by one company which have been paid from the profits of another company earned before its shares were acquired by the shareholder company.

I. DIVIDEND FROM REVALUATION RESERVES

This part of the paper is concerned with dividends from the surplus arising from an estimated but unrealised accretion to fixed assets. This accretion may be brought into the accounts by writing up the asset value and carrying the surplus to a revaluation reserve.[17]

Fixed Assets Defined

Para. 3 (2) of the Eighth Schedule to the Companies Act 1955 requires assets to be classified under separate headings in the balance sheet of "Current Assets" and "Fixed Assets".

The Statement of Accounting Practice of the New Zealand Society of Accountants on *Presentation of Company Balance Sheets and Profit and Loss Accounts*[18] makes the following comment:

Fixed Assets

The fundamental characteristic of fixed assets is that they are held with the object of earning revenue, directly or indirectly and not for the purpose of sale in the ordinary course of business. They normally include such assets as:

(a) Land and buildings.
(b) Leaseholds.
(c) Plant and machinery and equipment.
(d) Investments intended to be held continuously by the business (including those in subsidiaries).
(e) Goodwill and patents.

Current Assets

In contrast with fixed assets, current assets are those held for realisation in the ordinary course of business and normally include:

(a) Stock-in-trade and work-in-progress.
(b) Accounts receivable including trade and other debtors, bills receivable and prepayments (other than those on capital expenditure or of a long-term nature).

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17. It may also be brought in by writing up assets and eliminating previous losses, a practice approved in *Ammonia Soda Co.* v. *Chamberlain* supra, n. 7.
18. Published by N.Z. Society of Accountants, Sept. 1966 under Code D 1, pp. 9, 10.

(c) Current portion of debts owing by subsidiaries, fellow subsidiaries and holding companies.
(d) Readily saleable investments held as part of the liquid resources of the company.
(e) Bank balances and cash.

In the past the case law has used different terminology, that of "fixed" and "circulating" capital, for the purpose of saying that fixed capital may be sunk and lost but circulating capital must be kept up.[19]

The case law distinctions and the accounting definitions are very similar. Land and buildings, for instance, were held to be fixed capital in *Ammonia,* leaseholds and goodwill were held to be fixed capital in *Wilmer* v. *McNamara & Co.* and plant and machinery in *re Kingston Cotton Mill (No. 2)*.[21]

There may be border line cases and items can be in both categories depending on the circumstances (e.g. plant and equipment would be current assets in the hands of a dealer in such items).

The distinction rests on the intention with which the asset is acquired and this in part may be deduced from the length of time the asset is held.

The Accounting Treatment of Unrealised Capital Appreciation

It is an important accounting principle that, with a few exceptions,[22] profit is not to be anticipated and cannot be brought into the books of a company unless it is actually realised by a sale of the asset or product to someone outside the company or group of companies. Thus an unrealised appreciation to the value of a fixed asset is not a profit in accounting terms and is not to be distributed. Similarly a profit or gain is not taxed until it is "derived".[23]

The accounting view point is perhaps best summed up by one of the submissions made by the Council of the Institute of Chartered Accountants in England and Wales to the United Kingdom Company Law Committee[24] in 1960:—

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19. *Verner* v. *General and Commercial Invesetment Trust* [1894] 2 Ch. 239, 266. These were explained by Swinfen Eady L.J. in *Ammonia Soda Co.* v. *Chamberlain* supra, n. 1 at pp. 286-287.
20. [1895] 2 Ch. 245.
21. Supra n. 7.
22. For instance, where the product is readily and easily saleable at a certain price, e.g. gold, or in the large construction field where a conservative estimate of profits on the basis of the proportion of total work done is permissible.
23. Section 88 (1) (a), (c) and (d) of the Land and Income Tax Act 1954.
24. Cmnd. 1749; 1962 The committee was chaired by Lord Jenkins and is hereinafter called "the Jenkins Committee".

> 138. If the fixed assets of a company are written up on the basis of a valuation it is important that the surplus arising from writing-up should be dealt with on sound accounting principles, which do not permit an unrealised surplus to be treated as available for distribution in cash or specie . . .[25]

In answer to a question from a member of the committee they agreed that to use such surplus for the issue of shares was permissible.[26]

Similar views were expressed by the Institute of Chartered Accountants of Scotland.[27]

Articles of Association

Even if the appreciation of the fixed assets is realised it may not be possible to pay the profit out without changing the company's articles. In *Re Metal Stores Ltd.*[28] the company articles followed Article 107 of Table A of the Second Schedule to the Companies Act 1908 and provided that "No dividends shall be payable except out of the net profits arising from the business of the company . . ." The profit there arose from the sale of land which sale was ancillary to the business of the company. Accordingly it was held by the Full Court[29] that a dividend from such profits was forbidden.

However, both Article 116 of Table A of the 3rd Schedule to the Companies Act 1955 and Article 91 of the 1933 Act provide that "No dividends shall be paid otherwise than out of profits" which would appear to be sufficiently wide to allow capital profits to be distributed.

Again, if the Articles prohibited dividends except out of "realised profits" they would have to be altered before any dividends could be paid from revaluation reserves, assuming that the law otherwise permits such dividends.[30]

Overall Position

Even a realised accertion to be a fixed asset may not be distributable —there must be an overall accretion to paid-up capital. In *Foster* v. *New Trinidad Lake Asphalt Co.*[31] for instance, the company sought to distribute a debt paid to it by a subsidiary which debt had not previously been shown in the books of the company. Byrne J. granted an injunction against such a dividend pending further evidence being furnished as to the value of the other assets. In the course of his judgment he states:

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25. Minutes of the Jenkins Committee. P. 1418.
26. Ibid., 1357, Question 6260.
27. Ibid., 1336, 1274 Question 6042.
28. [1927] G.L.R. 319.
29. Sim, Stringer and Hardman JJ.
30. Forwhat are "realised profits" see *Re Oxford Benefit Building and Investment Society* (1886) 35 Ch.D. 502, 510 per Kay J.
31. [1901] 1 Ch. 208.

> the question of what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year, capital, as well as profit and loss, and although dividends may be paid out of earned profits in proper cases, although there has been a depreciation of capital, I do not think that a realised accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible among shareholders without reference to the result of the whole accounts fairly taken.[32]

This principle was applied by the High Court of Australia in *Australasian Oil Exploration Ltd.* v. *Lachberg*[33] where the company sought to sell its most valuable asset for an inadequate cash price. The purchaser was also to enter into a share deal direct with the vendor's shareholders. It was argued that this was an unauthorised reduction of capital, but the company sought to rebut this by saying that

> if a comany engages in a transaction whereby it disposes otherwise than in the course of its trading or business activities, of a single capital asset for a price in excess of the value at which that asset stands in its books, it may lawfully distribute the casual profit so made among the shareholders whatever the capital position of the company might otherwise be.

The High Court replied:

> This proposition was emphatically rejected by Wolff J. [the Judge at first instance] and we agree with him in thinking this is not the law. It is enough on the point to say that a company has no capital profits available for dividend purposes unless upon a balance of account it appears that there has been an accretion to paid up capital.[35]

Whether or not a valuation of the other fixed assets is required is uncertain although this seems to be the point of *Foster* because some accounts were before the court there. This is also suggested by the expression "fairly taken". On the other hand "balance of account" in *Australasian Oil Exploration* suggests that book values might suffice. A general revaluation was considered desirable by the Institute of Chartered Accountants of Scotland in answer to a question from the Jenkins Committee[36] and the Royal Commission on the Taxation of Profits and

32. Ibid., 212.
33. (1959) 101 C.L.R. 119.
34. Ibid., 133.
35. Idem. This conclusion has been reached in South Africa also. See *Liddell* v. *Commissioner for Inland Revenue* [1939] C.P.D. The qualification was not however, mentioned in *Ammonia Soda Co.* v. *Chamberlain* or *Dimbula Valley (Ceylon) Tea Co. Ltd* v. *Laurie* [1961] Ch. 353 but neither of these cases were concerned with this particular point.
36. Minutes of Jenkins Committee 1274, Question 6049.

Income[37] assumes that it is required. The Jenkins Committee merely recommended that such profit be distributable "if the directors are satisfied that there is a net surplus."[38]

Restoration of Depreciation Written off

If a company writes off to its revenue account depreciation on its fixed assets it seems clear that it can at a later stage write back this depreciation should the depreciated asset appreciate in value. Such writing back would be permissible to the extent of the appreciation as disclosed by a bona fide valuation. This was what was done in *Ammonia Soda Co.* v. *Chamberlain*[39] where Peterson J. at the first instance said:

> the effect is that the value of assets as shown in the account is diminished by the amount of the depreciation fund. If the assets in fact increased in value to the extent of the depreciation fund, there is no rule which prohibits a company from wiping out the depreciation fund from the liabilities side of the account.

Swinfen Eady L.J. in the Court of Appeal[40] referring to the allowance for depreciation made by the company pointed out that "there is no evidence of any actual depreciation of these items during this period". This rule of law may be justified on accounting grounds for

> depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him.[41]

Accordingly there is no depreciation if a fixed asset, having been used by its owner, can be sold for more than it cost him.[42] *Ammonia* also decided that an accretion to fixed assets can be used in writing off past losses.

This case was taken a stage further in *Stapley* v. *Read Brothers Ltd.*[43] where goodwill had been written down against a profit reserve and eventually written out of the accounts. The company later made losses followed by a profit and to enable it to pay the preference dividend with arrears it proposed to write up goodwill and write back the profit reserve. It was accepted that the goodwill was at least equal

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37. *Report of the Royal Commission on the Taxation of Profits and Income* 1955, Cmnd. 9474 para. 805.
38. Jenkins Report 1962, Cmnd. 1749, para. 350 (a).
39. Supra n. 7, at 276.
40. Ibid., 289.
41. *Recommendations on Accounting Principles,* N.Z. Society of Accountants, 1946. These recommendations are based on the recommendations of the Institute of Chartered Accountants in England and Wales of 1945.
42. *Ammonia Soda Co.* v. *Chamberlain* [1918] 1 Ch. 266 applied on this point by Lord Sorn in *Westburn Sugar Refineries* v. *Inland Revenue Commissioners* (1960) 39 Tax Cas. 45.
43. [1924] 2 Ch. 1.

to the written up value and it was held by Russell J. that this proposal was permissible. If instead of writing off the goodwill the company had carried the profits to a goodwill depreciation reserve this could have been written back to the extent the value exceeded the depreciated book value. Russell J. did not think the difference of accounting affected the situation.

Bonus Issue of Shares

Whether an unrealised accretion to a fixed asset can be capitalised and distributed by way of additional shares (commonly but inaccurately known as "a bonus issue") has only been specifically considered in one reported case.[44]

Prior to that decision it had been assumed that reserves arising from revaluation of fixed assets could be capitalised. For instance, Westburn Sugar Refineries Ltd in 1948 revalued its fixed assets creating a capital reserve. The following year it capitalised a substantial proportion of this reserve and then sought to reduce its capital. This reduction was finally confirmed by the House of Lords in *Ex parte Westburn Sugar Refineries Limited*[45] but the propriety of such capitalisation was not questioned there nor in the later case of *Westburn Sugar Refineries Ltd.* v. *Inland Revenue Commissioners.*[46]

Thus in the *Dimbula Valley* case Buckley J. states

> "It has, I think long been the generally accepted 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 *Inland Revenue Commissioners* v. *Thornton Kelly & Co. Ltd.* [1957] 1 W.L.R. 482. Indeed as I have pointed out, this was actually done by Westburn Sugar Refineries Ltd. For myself, I see no reason why, if the valuation is not open to criticism, this should not be so . . .[47]

The judge accordingly held that the issue of shares was permissible but note the qualification that the valuation must be in good faith by competent valuers and not subject to short-term fluctuations. There seems little reason to upset such a decision for it does not contravene accepted accounting practice. To do so would involve the court in interfering with decisions of men of business which, as observed above, it is reluctant to do, and further the interests of creditors are not prejudiced for no money or assets actually leave the hands of the company.

44. *Dimbula Valley Ceylon Tea Co.* v. *Laurie* [1961] Ch. 353.
45. [1951] A.C. 625.
46. [1960] S.L.T. 297, (1960) 39 Tax Cas. 45 (Scottish Court of Sessions) discussed at p. 514 infra.
47. *Dimbula Valley Ceylon Tea Co.* v. *Laurie* supra n. 44 at pp. 372, 373.

The argument used by counsel in *Dimbula Valley* opposing such capitalisation was that a revaluation reserve "could not have been legitimately distributed by way of dividend (*Westburn Sugar Refineries Limited* v. *Inland Revenue Commissioners* [1960] T.R. 105) and therefore it cannot legitimately be capitalised."[48] Buckley J., however, refused to follow *Westburn* rejecting the hypothesis that such a reserve could not be distributed by way of dividend. Whether he was correct in this must now be considered.

Distribution of Revaluation Reserves in Cash or Specie

Here as noted above there is a conflict of authorities between *Westburn Sugar Refineries Ltd* v. *Inland Revenue Commissioners*[49] and *Dimbula Valley (Ceylon) Tea Co. Ltd.* v. *Laurie*[50] and also *The Midland Land and Investment Corporation Ltd.*[51] This latter case has yet to be judicially considered and was not cited to or by the court in either *Westburn* or *Dimbula Valley.* In it the directors of a land company had employed an expert valuer to value the company's assets consisting of buildings, land, ground rents, contracts and options. The directors prepared a balance sheet on the basis of this valuation and it showed a surplus of some £100,000 of assets over liabilities. Out of this surplus the directors distributed £20,000. In many cases the assets had been valued at more than cost and much more than they afterwards realised. It was contended that the dividend ought not to have been paid out of profits which rested on an estimate but Chitty J. held that the directors were not liable stating:

> that in declaring a dividend in trading concerns directors are entitled to put an estimate on the value of their assets from time to time in order to ascertain whether there is or is not a surplus remaining, after providing for liabilities; and where they make those valuations from time to time on a just and fair basis, and take all the precautions which ordinary men of business engaged in a similar business would do, they are entitled to treat the surplus thus ascertained as profits.

This statement is of a wide nature and suggests that unrealised accretions to assets of any kind may be used. It can, however, be argued that as the company was dealing in land the assets were current assets (i.e. "circulating capital") and so the unrealised profits were revenue and not capital profits. Ordinarily trading accounts generally require an estimate of the value of opening and closing stock which is what the land is here. However, it is not accepted accounting practice to value stock above cost except in some special types of business such

48. Ibid., 360-361.
49. Supra, n. 46.
50. Supra, n. 47.
51. (1886) unreported but referred to in *Palmer's Company Precedents* (17th ed. 1956) 630.

as tea and rubber producing companies and some mining companies or where there are long term contracts.[52]

The Midland Investment Corporation dicta is unlikely to be followed in its present wide form for it makes no reference to valuation in good faith by competent valuers nor to the liability to short-term fluctuations both of which were noted by Buckley J. in *Dimbula.*[53] This might be acceptable in respect of stock-in-trade where, because the sale of the stock is the directors' business, the directors can be expected to have some knowledge of market prices just as others in a similar business would have. Also the company will intend to quit the stocks as soon as reasonably possible. Even here problems of a sudden slump can arise. The slight slump in 1961 in Australia, for instance, left the Reid Murray land companies with large amounts of land assets which were unsaleable at the value placed on them by Reid Murray for accounting purposes. This problem would be accentuated if applied to fixed assets where the directors are much less likely to make a competent valuation and where the assets are more likely to be subjected to fluctuations in market value, especially as their value is an assessment of earning capacity which may reflect management ability as well as the state of the market at any one time.

It is submitted that the holding of Chitty J. should be, at the best, restricted to stock-in-trade.[54] However, a valuation by directors was accepted in *Ammonia Soda Co.* v. *Chamberlain*[55] where the increase was used to write off past losses largely arising from depreciation allowances made in the assets. Both Swinfen Eady and Warrington L.JJ. accepted the revaluation as the directors honestly held, upon reasonable grounds, the opinion that the assets were worth what they estimated the assets were worth. The learned judges also considered that it was a fair valuation[56] and the directors' action had been approved by the company in general meeting. On the other hand, Scrutton L.J., felt that

> if it were necessary for me to find that they acted reasonably I should have wished to hear Mr Clauson [counsel for the respondent directors], because at present I am not satisfied as to their reasonable business conduct. But in my view it is not necessary for me to decide that in fact.[57]

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52. *Recommendation on Accounting Principles N. 22,* Institute of Chartered Accountants in England and Wales, 1960, paras. 3, 20, 21, 22 and 30.
53. Supra n. 47 at p. 93.
54. Romer J. in *Bolton* v. *Natal Land and Colonisation Co.* [1892] 2 Ch. 124, 133 would not even sanction profit including nominal increases in the value of stock. Chitty J. was probably influenced by the relative "youth" of joint stock companies as perpetual enterprises and, also the earlier concept of a joint venture allowed for the valuing of *all* assets on taking of accounts.
55. [1918] 1 Ch. 266.
56. Ibid., 290, 291.
57. Ibid., 295.

To the extent that the directors' valuation was only a restoration of the depreciation provision, this is in harmony with accounting practice for it is usual for the company to decide allowances of depreciation without reference to independent expert valuers. The extent to which the decision is applicable in a wider context is doubtful in view of the dicta of Buckley J. in *Dimbula Valley* quoted abov.

Even before the *Westburn-Dimbula Valley* conflict there was uncertainty whether an unrealised accretion to fixed assets could be distributed or not.[58]

On the one hand there was the *Ammonia Soda Company*[59] case and *Stapley* v. *Read Bros Ltd.*[60] but these cases really only decided that the revaluation can be used to write off past losses and in particular for the restoration of depreciation (see above). Peterson J. at least, in *Ammonia Soda Company*[61] at the first instance, did not intend the case to be extended beyond this for he said:

> It is one thing to treat an unrealised increase in value of a fixed asset as profit and to pay dividends out of it as profits; but it appears to me to be a different question whether in considering whether there is a deficiency in paid-up capital owing to past losses, which ought to be made good out of future profits, the real value of the assets can be ascertained with the object of discovering if in fact there is a deficiency in the paid-up capital.

A further distinguishing feature of *Ammonia Soda Company* noted by Lord Sorn in *Westburn Sugar Refineries Ltd* v. *Inland Revenue Commissioners*[62] was that the loss there had been incurred mainly in development of the property which was later revalued "and so partook of the nature of a capital loss". This feature, though, did not appear to influence any of the judges in that case.

On the other hand there is a series of judicial dicta referred to by the Court in *Westburn* which assume that capital accretions must be realised before they can be distributed.

In *Verner* v. *General and Commercial Investment Trust,*[63] for instance, Lindley L.J. in delivering the judgment of A. L. Smith, L.J. and himself, commented that

> Accretions to that capital [i.e. subscribed capital] may be realised and turned into money which may be divided amongst the shareholders, as was decided in *Lubbock* v. *British Bank of South America* [1892] 2 Ch. 198.

58. 6 *Halsbury's Laws of England* 3rd ed. 400 n. (g) and Gower *Modern Company Law* (2nd ed. 1957) p. 110.
59. Supra n. 55.
60. [1924] 2 Ch. 1.
61. Supra n. 55, p. 277.
62. (1960) 39 Tax Cas. 45, 61.
63. [1894] 2 Ch. 239, 265, C.A.

As Lord Sorn pointed out in *Westburn* "this passage seems . . . inconsistent with the idea that accretions to capital yet unrealised can be made use of for the payment of dividends"[64] Also in *Verner* Kay L.J. said:

> so if the capital had been increased by a rise in the value of the investment, I conceive that they might have realised some part of that increase, and distributed it as dividend.[65]

Again, in *Foster* v. *New Trinidad Lake Asphalt Co. Ltd.*[66] Byrne J. said

> It is clear, I think, that an appreciation in total value of capital assets, if duly realised by sale or getting in of some portion of such assets, may in the proper case be treated as available for the purposes of dividend.

Romer J. in *Bolton* v. *Natal Land and Colonisation Company*[67] stated

> it was an erroneous method of estimating their profits to have brought in as part of the profits of the year an increase or nominal increase [meaning the revaluation surplus], of the value of their property in *Africa.*

In *Verner* and *Foster* the issue was not before the court and no argument on the point was presented but in *Bolton* it was specifically submitted by counsel for the plaintiff that the company should not have distributed the estimated increase in value of the company's land even assuming the valuation was correct,[68].

The question at issue in *Westburn Sugar Refineries Ltd* v. *Inland Revenue Commissioners* was whether the revaluation reserve was a "distributable sum" within the meaning of section 31 (5) of the Finance Act 1951 which referred to distributions within the meaning of section 36 (1) of the Finance Act 1947. That Act in turn set out that a distribution took place where "any amount is distributed directly or indirectly by way of dividend or cash bonus to any person; or (b) assets are distributed in kind to any person."

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64. Supra n. 62, p. 265.
65. Supra n. 63, p. 269.
66. [1901] 1 Ch. 208, 212.
67. [1892] 2 Ch. 124, 133.
68. Further support may possibly be gleaned from a dictum of Lopes L.J. in *Lee v. Neuchatel Asphalt Co.* (1889) 41 Ch.D. 1, 26-27, C.A. cited by Stirling J. in *Verner* v. *General and Commercial Investment Trust* [1894] 2 Ch. 239, 253-254. This dictum cannot apply to realised capital gains. See *Lubbock* v. *British Bank of South America* [1892] 2 Ch. 198, 202 per Chitty J. and the pronouncements of Lindley and Kay L. JJ. quoted at p. ?? ante. It is accordingly uncertain whether to restrict this dictum to refer to an unrealised capital accretion, a proposition for which it was cited by counsel in *Ammonia* at p. 281, or to dismiss it completely. The diminution of capital in *Lee* which gave rise to the dictum had not, however, been realised.

It was contended on behalf of Westburn Sugar Refineries that the revaluation surplus was not a "distributable sum" as it could not be distributed by way of dividend or cash bonus. The Inland Revenue Comissioners argued that it could be in view of the strong financial position of the company.

The Lord President[69] held that the revaluation surplus was not available for distribution

> For it represented an unrealised increment in value of certain assets of the company, and in no way resembled a realised sum of money. It was not even a separable part of the fixed assets which could have been sold for money or moneys worth.[70]

He then proceeded to hold as a separate ground[71] that it would be contrary to law for the company to have distributed the surplus, referring to *Palmer's Company Law*.[72] This passage pointed out that accounting and business practice regarded such a reserve as unavailable for distribution. It then submitted that although in practice it was rarely permissible and even highly undesirable immediately realisable accretions to fixed assets which were proved to exist could be distributed although subject to the risk of incorrect valuation. The passage did not say that it was illegal to distribute unrealised accretions but there was this implication in relation to accretions which are not immediately realisable. The Lord President, continued

> I am of the opinion that these observations are sound, and that particularly in the case of an appreciation which is neither realised nor immediately realisable it would be illegal to distribute the surplus.[73]

Lord Clyde strengthened his ruling by referring to evidence of accounting practice[74] and to the position of creditors:

> It appears to me that were the Courts to hold otherwise it would involve opening the door to dangerously premature distributions of funds of a company which a change in economic or trading conditions might promise to be disastrous

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69. Lord Clyde.
70. *Westburn* supra n. 62, p. 57.
71. It is questionable if this was in fact a separate ground in view of the wide definition given to distribution in s. 36 (1). Lord Sorn did not make a similar distinction.
72. *Palmer's Company Law* (20th ed. 1959) 654, now p. 671-672 of the 21st ed. 1968.
73. Supra n. 62, p. 57. By using the words "in particular" he to some extent contradicts himself for this suggests that even if the accretion is immediately realisable, it is not distributable, but this is contrary to the submission in *Palmer* which he termed sound.
74. Ibid., 58: "This certainly accords with the uncontradicted evidence in this case of the practice amongst chartered accountants."

> after the lapse of a few years. For nowadays particularly the values of fixed assets may fluctuate heavily.[75]

Lords Carmont and Russell agreed in this judgment. Lord Sorn, although he dissented on another point, agreed with the conclusion reached here by Lord Clyde saying "In my view capital profits are not distributable until they are realised."[76] He then analysed the judicial dicta cited above and concluded that they supported him. Both he and the Lord President distinguished the *Ammonia Soda Company* case as being highly special and involving not a distribution of revaluation surplus but a writing off of previous losses.

The decision protects creditors and does not require the court to interfere unnecessarily with the decisions of men of business for it is supported by accounting practice which probably would be known by the directors of a company proposing to make such a distribution. *Lee* v. *Neuchatel Asphalte Co.*[77] and *Verner* v. *General and Commercial Investment Trust*[78] are not decisive as it was there held that capital losses need not be made up from revenue profits but here the question is not whether the profits should be distributed in a particular case but whether a particular type of surplus is a distributable profit at all.

Confusion and uncertainty has arisen, however, as a result of the decision in *Dimbula Valley (Ceylon) Tea Co. Ltd.* v. *Laurie.*[79] There Buckley J., in considering if an unrealised surplus can be capitalised, refused to follow *Westburn.*

The learned judge disagreed with the Lord President's reading of the passage in *Palmer's Company Law* which he read as saying

> that by law an unrealised profit resulting merely from revaluation of fixed assets can be treated as a profit for dividend purposes, but that this is not normally to be regarded as wise commercial practice.[80]

It should be noticed, however, that *Palmer* confined the proposition to *immediately* realisable accretions and was silent on the general question.

With reference to the dicta in *Verner* and *Foster* Buckley J. said that these cases related to realised capital appreciation. While this is true of *Foster* it is not of *Verner* although the decision itself in *Verner* is not in point. *Bolton* v. *Natal Land and Colonisation Co.*[81] was dismissed on the grounds that "the decision . . . has no bearing on the question I am considering"[82] but one of the submissions of counsel in

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75. Ibid., 58.
76. Ibid., 60.
77. (1889) 41 Ch. D. 1, C.A.
78. [1894] 2 Ch. 239, C.A.
79. [1961] Ch. 353.
80. Ibid., 371.
81. [1892] 2 Ch. 124.
82. Ibid., 373.

that case was that a company could not pay dividends from revaluation reserves. It is submitted that Buckley J. does not give enough weight to these dicta which come from four different judges and which are uncontradicted either directly or indirectly in any other case.

Buckley J. could see nothing wrong in basing a profit calculation on an estimate since every profit and loss account includes an opening and closing stock figure which necessarily involves an estimate. This is certainly correct and could be extended to the depreciation calculations as well. However a distinction can be drawn between the estimate required for stock purposes and that used in increasing the value of a fixed asset. As pointed out earlier[83], stock should not be carried at above cost except in special circumstances and allowance should be made for damaged, obsolescent and slow moving stock. Just what is cost will involve an estimate as well but both here and with obsolesence the estimate must be conservative so that profit is not anticipated. With depreciation the alternative to not making an estimate would be not to allow any depreciation at all which is not, although permitted by law,[84] sound accounting practice. Thus, for both stock figures and for depreciation, estimates are required in the ordinary course of preparation of the profit and loss account. The estimate of an unrealised accretion to capital, however, is a voluntary and positive step taken by the company which is not required by ordinary accounting practice. Indeed the Institute of Chartered Accountants in England and Wales[85] recommends

> (d) For balance sheet purposes fixed assets should not (except in special circumstances, such as those referred to in paragraph 297, be written up especially in the absence of monetary stability.[86]

Further, the increase in surplus from revaluing fixed assets is likely to be much more significant overall than the effect of estimates of opening and closing stock and depreciation, especially as the basis of estimation should not be changed from year to year without full disclosure—8th Schedule, Companies Act 1955 para. 15 (4) (c). Buckley J's point has some validity but is not, it is submitted, very convincing.

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83. Ante, page 511.
84. *Lee* v. *Neuchatel Asphalte Co.* and *Re Kingston Cotton Mill* supra n. 7.
85. *Recommendation on Accounting Principles* XV, Institute of Chartered Accountants in England and Wales 1952.
86. The special circumstances referred to in para. 297 are where a subsidiary is acquired and the assets are written up to reflect the cost to the acquiring company, or where subscriptions for new capital are invited on the basis of a current valuation of the assets.
    Since the Recommendation there has been more argument in favour of revaluation but the controversy over a stable accounting unit still continues. This controversy may eventually affect the ultimate approach to this question. One disadvantage in revaluing an asset to its full realisable value is that if the asset is then retained the tax write-off is lost, so that the asset is less valuable in the company's hands than its commercial value suggests.

Also, Buckley J. does not appear to take sufficient notice of the position of the creditor. The only reference to the creditors is on page 373 where, having said that he saw nothing wrong in making a dividend payment from available fluid assets but treating it, for accounting purposes, as being from the surplus resulting from an unrealised appreciation in fixed assets he continues:—

> The proper balance of the company's balance-sheet would not be disturbed by such a course of action. The company would be left with assets of sufficient value to meet commitments shown on the liabilities side of its balance-sheet, including paid-up share capital.

This dictum assumes that the valuation was a reasonable one but it may be that the valuation, although bona fide, was excessive. Even if the valuation is not bona fide, the creditor is not likely to be able to contest the payment of a dividend from the resulting surplus. A creditor cannot even apply to the court to restrain the company from paying a dividend out of capital unless he has a security (meaning something more than a floating debenture) which is in jeopardy.[87] Unsecured creditors seem only to be able to apply to have the company wound-up leaving it to the liquidator to bring misfeasance proceedings against the directors (which may be too late).[88] Consequently it is unlikely that the court would permit a creditor to dispute a valuation and resulting dividend. A total ban would at least permit a shareholder[89] or liquidator to bring an action against the directors and would bar honest directors from declaring such dividends.

A creditor may thus lend money to a company relying on the current value of assets over liabilities only to see much of his security disappear and even although the balance sheet may at present represent reliable current values these might later fall considerably before the asset is sold.

The learned judge did make at page 372 a qualification in this regard when referring to capitalisation of the profits[90] but it is questionable if this adequately qualifies the later statement and if dividends are permissible it would be only in the extreme case that a court would upset the director's decision of what surplus is "not likely to be liable to short-term fluctuations".

Further, there is no obligation on the directors, having revealed the asset, to allow for any depreciation or capital loss before distributing

87. *Mills* v. *Northern Railway of Buenos Aires* (1870) 5 Ch. App. 621 and *Lawrence* v. *West Somerset Mineral Railway* [1918] 2 Ch. 250.
88. *Coxon* v. *Gorst* [1891] 2 Ch. 73.
89. Otherwise even a shareholder would have difficulty in disputing the valuation because of the Rule of *Foss* v. *Harbottle* (1843) 2 Hare 460. See *Stevens* v. *South Devon Railway Co* (1851) 9 Hare 313, 330.
90. See p. 511 ante. Also *Ammonia* supra n. 7 at p. 277 Peterson J. stated, "Directors would no doubt not be justified in ascribing to a fixed asset a value which is the result of purely temporary fluctuations."

income arising in some later period as profit.[91] It is therefore submitted, that while *Dimbula* was correctly decided on the issue before the court, namely the capitalisation of revaluation reserves, the pronouncements of Buckley J. were obiter and incorrect in so far as he maintained that dividends could be paid out of such reserves.

How then can such a conclusion be reconciled with the structure of the judgment and in particular the statement by Buckley J. that

> If, therefore, the Court of Session was right in holding that a reserve fund constituted as a result of a revaluation of unrealised fixed assets could not legally be distributed, it would seem to me to follow that it likewise could not legally be capitalised.[92]

Quite apart from the difference in accepted accounting practice, from the point of view of the creditors there is a considerable difference between the issue of additional paid-up shares and the payment of a dividend. In the former case the revaluation surplus is locked into the company's capital structure and cannot be returned to the shareholders without the sanction of the court. In the latter case the surplus leaves the company and is lost to its creditors forever.

No authority is cited for the observation by Buckley J. but it follows from his earlier conclusion on the same page that

> a capitalisation of this sort is in essence the declaration of a dividend combined with the application of that dividend on behalf of the shareholders entitled to participate in it in paying up shares to be alloted and issued to them in satisfaction of their rights of participation—see *Hill* v. *Permanent Trustee Co. of New South Wales Ltd.* [1930] A.C. 720, P.C. As a general rule only that which could be distributed in dividends can be capitalised.

While the first sentence correctly sets out the machinery of the capitalisation it is submitted it does not do more. In *Bouch* v. *Sproule*[93] for instance, a company declared a large dividend and at the same time alloted shares to shareholders on terms which compared favourably with the current price. A call was made on the shares which was of the same amount as the dividend and the dividend warrant was sent to the shareholders with the option for them to apply it in payment of calls. A dispute arose whether the shares belonged to the life tenant or the remainderman of an estate which held shares in the company. If the company had truly paid a dividend which was then reapplied in subscribing for the shares they must belong to the life tenant. It was held by the House of Lords that the company did not pay or intend to pay

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91. *Lee* v. *Neuchatel Asphalte Co.* and *Verner* v. *General & Commercial Trust* Supra n. 68 and *Re Kingston Cotton Mill (No. 2)* [1896] 2 Ch. 279, C.A.
92. *Dimbula Valley (Ceylon) Tea Co.* v. *Laurie* supra n. 44 at 372.
93. (1887) 12 App. Cas. 385.

any sum as a dividend and so the shares belonged to the capital of the estate.[94]

In *Inland Revenue Commissioners* v. *Blott*[95] a company again declared a bonus dividend but at the same time authorised the directors to issue bonus shares in satisfaction of the dividend. Blott was assessed with super tax on the amount of the dividend. The House of Lords rejected the assessment ruling that the declaration of dividend was "bare machinery".

> I do not think that there is a payment of a dividend to a shareholder unless a part of the profits of the company is thereby liberated to him in the sense that the company parts with it and he takes it.[96]

Swan Brewery Company Ltd v. *The King*[97] perhaps offers strongest support for the proposition advanced by Buckley J. but wide application of this decision was considered wrong in *Blott* by Viscounts Haldane, Finlay and Cave[98]. Even there Lord Sumner said

> In ordinary language the new shares would not be called a dividend nor would the allotment of them be a distribution of a dividend. The question in issue here is whether or not the new shares were a dividend under the Act abovementioned.[99]

Thus it is submitted that, although the machinery of a capitalisation is a dividend followed by an applicatoin of the dividend in paying up the shares, this is not its legal effect. The shareholders do not receive a dividend, so, it is submitted, the amount used in capitalisation need not be distributable *as a dividend* in its present form. There is nothing in *Hill* v. *Permanent Trustee Co. of New South Wales Ltd.*[1] which contradicts this and indeed Lord Russell of Killowen[2] points out the difference from the company's point of view between paying out dividends and issuing shares.

Even with capitalisation of revaluation reserves the amount that a company can distribute, without reducing its capital, has been reduced by the amount of the capitalisation as far as capital profits are concerned. If the revalued asset is sold at its new value there is no distributable profit as this has been anticipated and capitalised. It must be a genuine anticipation of profit, though, for distribution of additional shares on the basis of unsound valuations may be most misleading to investors

94. Ibid, 339 per Lord Herschell.
95. [1921] 2 A.C. 171.
96. Rowlatt J. at first instance in [1920] 1 K.B. 114, 133 cited with approval by Viscount Finlay in the House of Lords at 194.
97. [1914] A.C. 231, 236 J.C.
98. Supra n. 95 at pp. 188, 199 and 202 respectively.
99. Ibid., 234.
1. [1930] A.C. 720, J.C.
2. Ibid., 732-733.

as well as being contrary to the principle of not issuing shares at a discount.[3]

If other fixed assets are sold at a profit, although the revalued asset has not been sold or has been sold at less than valuation, these profits may have to be retained because of the overall position requirement noted above. The problem of who should receive the shares if the rights of various classes of shares to participate in profits differed from their rights on winding up, noted by Buckley J.[4] can be solved by looking at who would receive realised capital profits if they were distributed. The legislature itself, with the share premium account and capital redemption reserve fund, does permit the capitalisation of reserves which are not ordinarily distributable—although as Buckley J. pointed out these are statutory creatures.[5]

It is accordingly submitted that the revaluation surplus can be capitalised although not immediately distributable, if there is a genuine expectation that it would have become distributable if not so capitalised.

Summary

The above discussion can be summarised as follows:

1. Revaluation reserves can be used:
   (a) to write off past losses and to recover depreciation reserves
   (b) to issue paid up share capital, if the valuation is bona fide and the surplus not likely to fluctuate. There would also have to be an overall surplus in the capital account.
2. They ought not to be used to pay dividends. There is, however, nothing to prevent the company issuing additional shares and then seeking a reduction of capital.[6]
3. As each case depends on its particular facts a later court may well follow *Dimbula* where, for example, a bona fide valuation is made, the articles permit it and the directors relied on *Dimbula*, which has been accepted as law by some text book writers.[7] A better course of action, it is submitted, would be to follow *Westburn* and exempt the directors from personal liability, under section 468 of the Companies Act 1955.

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3. [1892] A.C. 125.
4. *Dimbula* supra n. 44, 372.
5. Furthermore, the share premium account was distributable before the Companies Act 1955. See *Drown* v. *Gaumont British Picture Corporation* [1937] Ch. 402.
6. For the principles applicable on a reduction of capital see *Re E. W. Mills & Co.* [1925] N.Z.L.R. 227.
7. Johnston, Edgar & Hays, *The Law and Practice of Company Accounting in New Zealand* (3rd ed. 1968) 170, and the 1968 Suplement to *Halsbury's Laws of England*, 3rd ed.

4. An increased value probably should not be attached to goodwill especially not for distribution purposes.[8]
5. Additional problems arise if the revaluation is immediately realisable for it was hinted in *Westburn*[9] that this may be distributable. It is difficult to see why any distinction should be drawn between that which is immediately realisable and that which is not. Because an asset is immediately realisable there is no guarantee that its value will be stable and is not likely to fall or that if it does fall that the company will decide to sell it any sooner than another asset. Such a distinction would only cause confusion and add more uncertainty to the law.
6. If revaluation reserves are capitalised they are not taxable at all but if they are distributed they are taxable in the hands of the shareholders.[10] This highlights the wisdom of not distributing the revaluation reserves. They were, however, distributable tax free before 1965. This does not effect the issue whether they can be legally distributed as the legislation is concerned only with raising revenue, not altering the general law.[11]

Practice

Two instances in which an issue of shares was made from revaluation reserves have already been noted—*Westburn Sugar Refineries Limited* and in the case of *Inland Revenue Commissioners* v. *Thornton Kelley & Co.*[12]

A recent instance on the New Zealand commercial scene was that of George Court and Sons Ltd. which on 3rd September 1969 announced a one for five bonus issue from revaluation reserves having made a one for four issue from the same source the previous year. In addition, in the previous year it paid a special bonus dividend of 1½% amounting to $7,500 out of a property revaluation reserve of $474,294.[13] The company also paid an ordinary dividend of 6% and had revenue reserves of $326,402 so that the capital dividend was comparatively insignificant.

In another recent case[14] a private company paid a dividend from the reserves arising on revaluation of goodwill. There the Board of

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8. *Re Spanish Prospecting Co. Ltd.* [1911] 1 Ch. 92, 105, C.A. per Fletcher Moulton J.
9. Supra n. 62 at p. 58 per Lord Clyde.
10. Sections 4 and 4 n (3) of the Land and Income Tax Act 1954.
11. *Dickson* v. *Commissioner of Taxation* (1940) A.L.T.R. 515, 517 per Latham C.J.
12. [1957] 1 W.L.R. 482 *Dickson* (supra) was another and see also *Warren* v. *Federal Commissioner of Taxation* (1959) 7 A.L.T.R. 539.
13. This revaluation reserve was classified in accordance with common practice as a capital reserve in the balance sheet but para 2 (1) (c) of the 8th Schedule, Companies Act 1955 provides that "The expression 'capital reserve' shall not include any amount regarded as free for distribution through the profit and loss account."
14. Case 312 N.Z.T.B.R. 20.

Review accepted *Dimbula* and made no reference to *re Spanish Prospecting Co. Ltd.* The issue before the Board, however, was the taxability and not the legality of the dividend.

A survey made by the writer of the ten New Zealand public companies most actively traded on the Stock Exchange[15] (all well established so that their assets are likely to be undervalued) revealed that since 1962 seven of the ten companies had made 10 "bonus issues". In seven cases the funds used in issuing the shares came from the schare premium reserve fund, in two cases all came from the profits accumulated prior to 1957 and in the tenth case three quarters of the funds came from revenue reserves accumulated prior to 1957, the remaining quarter coming from realised capital profits. None of the companies appeared to have paid dividends from revaluation reserves.

Thus although revaluation reserves are used by companies for bonus issues they are not the usual source of such issues. Further, the practice of paying dividends from such reserves may be restricted to the private and smaller public companies.

Law Reform

In considering the question of reform several factors are relevant —the protection of creditors and future shareholders, protection of existing shareholders, a minimum of interference with legitimate business practice, and public policy.

For the reasons advanced above it is considered that protection of creditors and future shareholders (who may suffer if they are misled by the valuation given to assets or by the size of the dividends in the past) warrants the prohibition of dividends from a capital surplus arising on revaluation of unrealised fixed assets, as was recommended by the Jenkins Committee.[16] This involves interference but this may be justified because of the support it receives from the accountancy profession. The existing shareholder is also affected but not unreasonably. His income from dividends from trading profits is not effected and with increasing asset backing there is the prospect of additional share and capital gains. Because of the conflict of authorities this prohibition should be made explicit by legislation.

The Jenkins Committee[17] were content with the capitalisation of such surplus if established by bona fide revaluation of all the assets. They also did not object to use of such reserves to write off past losses if other reserves except share premium and capital redemption reserves had been previously exhausted. The committee suggested that the dis-

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15. Alex. Harvey Industries Ltd., Dominion Breweries Ltd., Fletcher Holdings Ltd., J. Wattie Canneries Ltd., New Zealand Breweries Ltd., New Zealand Forest Products Ltd., New Zealand Insurance Co. Ltd., South British Insurance Co. Ltd., U.E.B. Industries Ltd and Wright Stephenson Ltd.
16. Jenkins Report para. 350 (b).
17. Ibid., para. 338.

tribution of an asset should be regarded as equivalent to its realisation. All this is unobjectionable.[18]

II. PRE-ACQUISITION PROFITS

Accounting Practice

Dividends received by one company which have been paid out of the profits of another company, earned before its shares were acquired by the shareholder company should not be distributed.[19] The reason given is that accumulated reserves of the other company will have been taken into account in calculating the price that the purchasing company was prepared to pay for the shares.[20] The dividend then, does not represent profit but a return of purchase price and so should not be distributable in the hands of the purchaser company.[21]

To distribute the return of the purchase price is to return capital. This is seen particularly where shares are issued in exchange for shares acquired because here the acquired shares are directly purchased with capital.

It has now become accepted accounting practice that if assets, including shares in another company, are acquired in exchange for the allotment of shares they should be brought into the books at either a fair value of the shares issued as consideration or a fair value of the property or right acquired whichever is more clearly evident. The difference between the cost found this way and the par value of the shares issued must be credited to a share premium reserve.[22]

The problem of distribution of pre-acquisition profits arises in particular with holding company-subsidiary relationships, probably because the accounting problems are more intricate here and the amounts involved more substantial. Also the holding company has more say in whether the subsidiary declares a dividend or not. This is not the exclusive area of the problem however, and with the increase of

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18. Only Harold Edey at p. 200 of the *Jenkins Minutes* and the Law Society at p. 1202 advocated anything else and their submissions were qualified.
19. Such dividends are, of convenience, termed "dividends from pre-acquisition profits". Apart from the general law relating to dividends there is nothing to prevent the subsidiary company distributing pre-acquisition revenue reserves.
20. The purchasing company, when calculating the purchase price, will also make allowance for any increased dividend requirements, but it would wish to meet these from future profits.
21. Evidence of Institute of Chartered Accountants in England and Wales to the Jenkins Committee pp. 1438-1441, and of the Institute of Chartered Accountants of Scotland p. 1336.
22. Johnston, Edgar and Hays, *The Law and Practice of Company Accounting in New Zealand* (3rd ed. 1968) p. 50 and New Zealand Society of Accountants' Statement of Accounting Practice, *Presentation of Company Balance Sheets and Profit and Loss Accounts* p. 12. See also "The City of London Real Property Case" (1964) 75 *Accountancy* 773 and 862.

large share exchanges between companies[23] the problem may well arise here also.

The Law

It is submitted that a return of purchase price is not distributable for this would be a return of capital within the meaning of the term as set out in *Trevor* v. *Whitworth*.[24] This can be seen from the following example. A company with $600 capital issues its shares for cash and then purchases a business for $600. The business assets are plant and equipment valued at $500 and $100 cash representing past profits. If the company now proposes to declare a dividend of $100 from the pre-acquisition profits it would be left with assets of $500 only and its capital will in effect have been repaid to the extent of $100.

The illustration can be taken a step further to the situation where the company purchases shares for $600 just before a dividend of $100 is paid, knowing that such a dividend is about to be paid. This too, would, if redistributed, amount to a return of capital although if companies in the ordinary way were liable for tax on such dividends the company would also be liable.[25] However the legislature is concerned with raising revenue as conveniently as reasonably possible and not with company law restrictions. Not to assess the recipient of the dividends in such circumstances would result in the considerable problems of assessing the vendor.

Although the general commercial situation where the problem of availability of pre-acquisition profits for dividends arises is infinitely more complicated then the simple situations outlined above it is submitted that such a problem involves the same basic elements.

The area where most difficulty arises is where shares are issued in exchange for other shares. Here there is a problem of what value is to be placed on the asset acquired. Should it be the nominal value of the shares issued or some other figure? If for instance a company with a capital of $600, instead of issuing the shares for cash, exchanged them for all the shares in another company which had net assets of say $1000, including reserves of $600 actually represented in cash, should the purchasing company show the value of the subsidiary as $600 being the nominal amount of the shares issued or $1000 representing the

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23. Recent examples in New Zealand of exchanges of shares are those between U.E.B. Industries Ltd. and New Zealand Forest Products Ltd. and between Trustees Executors and Agency Co. of N.Z. Ltd and the National Insurance Co. Ltd. The sale of assets to an existing company in exchange for a substantial shareholding in that company but not absolute majority interest has also been popular e.g., Wright Stephenson Ltd and Hays Ltd., U.E.B. Industries Ltd. and Mosgiel Woollen Mills Ltd.
24. (1887) 12 App. Cas. 409, and in *Jenkins* v. *Harbour View Flats Ltd.* [1966] N.Z.L.R. 1, C.A.
25. *Inland Revenue Commissioners* v. *Pilcher* (1949) 31 Tax Cas. 314, C.A. Here a person purchased a cherry farm with the cherries almost ready for picking. The purchase price was held not to be apportionable.

underlying assets which is has in effect acquired? Common sense and accounting practice suggest the latter. If the subsidiary now declares a dividend of $600 it is submitted that this should be regarded as a return of purchase price and should be used in writing down the value of the subsidiary in the books of the purchaser company.

Section 64

Section 64 (1) provides that

> where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account to be called "the share premium account" . . .

The effect of this section was considered in *Henry Head & Co Ltd* v. *Ropner Holdings Ltd.*[26] where a holding company was incorporated for the purposes of amalgamating two shipping companies. After valuation of the assets of the two companies a dividend was declared by one to adjust reserves and then the holding company, Ropner Holdings Limited, acquired the shares of both companies by a share for share exchange. Ropner Holdings Limited brought the investment in subsidiaries in to its books at the amount of the valuation less dividend. On the basis of the equivalent English section,[27] it created a share premium account for the excess of the valuation over the nominal value of the shares issued.

A shareholder contested this method of accounting. Harman J. held that the holding company was obliged to show its accounts in this way. The judge could not see what "otherwise" in the section could mean apart from consideration in goods and assets and he was not prepared to restrict the section to the case where the company has been already trading. Instead he laid down that

> if the shares are issued for a consideration other than cash and the value of the assets acquired is more than the nominal value of the shares issued, you have issued shares at a premium.[28]

To avoid the "rigidity" that results it has been suggested by some writers[29] that section 64 applies only where either, on the face of the transaction, a premium is expressly provided (such as where shares are issued in redemption of debentures which have a face value of more than the nominal value of the shares issued) or where a premium is reflected in the entries in the books of the company relating to the transaction.

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26. [1952] Ch. 124.
27. Section 56.
28. Supra, p. 128.
29. Instone. [1959] B.T.R. 187.

It is argued that *Henry Head* is an example of the latter situation and that it should be restricted to that situation.[30] Support for this interpretation of the section is drawn from the failure of the legislature to provide a means of estimating the value of the premium. Instead the legislature refers to "value" as if it were well defined. This argument continues that where the legislature requires an estimate it specifically says so and the English writers refer to their section 196 (2). The equivalent New Zealand section,[31] does not however, use the term "estimated" so this argument here loses much of its force although the legislature in New Zealand does refer to "estimated" in para. 11 of the Fourth Schedule[32] and in para. 9 (5) and (6) of the Eighth Schedule.[33]

Instone also suggests, in para. 5 (b) of his article[34] that by para. 16 (2) (b) of the English Schedule a company is expressly relieved from valuing shares in a subsidiary in accordance with the normal rules for valuing fixed assets as provided by para. 11 of the Eighth Schedule. It is submitted that this is incorrect. What para. 16 (2) (b) does is exempt the holding company from having to show the amount of depreciation written off from the investment just as para. 11 (2) (b) and (c) does not require this for other investments where such a figure would not be particularly meaningful.

Only the most ill-managed companies would issue shares in consideration for assets without having at least an approximate idea of the cash price they would be prepared to pay for the assets. The courts do not require an exact figure fixed by some independent valuer but are prepared to accept the company's valuation of the consideration as conclusive[35] unless it appears inadequate on the face of the transaction[36] or there is an absence of bona fides.[37] True, a company does not have to issue shares at above par[38] but what is at issue here is not the adequacy of the consideration from a contractual point of view but the amount of the consideration for accounting purposes.

The artificiality of the argument can be seen from comparing the following examples:

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30. This seems an unduly narrow interpretation of the case for although a valuation had been obtained for the purpose of amalgamation this was not considered material by the judge. It also entails dismissing contrary dicta on the judgment.
31. Section 196 (4).
32. Paragraph 12 in the U.K. Act.
33. Paragraph 11 (5) and (6) in the U.K. Act.
34. Supra, n. 29.
35. *Re Wragg* [1897] 1 Ch. 796, C.A.
36. *Re White Star Line* [1938] Ch. 458, C.A. and see also *Craddock* v. *Zevo Finance Co.* (1946) 27 Tax Cas. 267, H.L.
37. *Tintin Exploration Syndicate* v. *Sandys* (1947) 177 L.T. 412.
38. *Hilder* v. *Dexter* [1902] A.C. 474, 480 per Lord Davey and *Lowry* v. *Consolidated African Selection Trust* [1940] A.C. 648, 669, per Lord Maugham, but contra Lord Wright at p. 679 and *Scottish Co-operative Wholesale Society Ltd* v. *Meyer* [1959] A.C. 324, 366 per Lord Denning.

(a) A company agrees to purchase 5,000 shares by issuing in exchange 10,000 of its $1.00 shares as fully paid.

(b) The facts as above but only 5,000 shares are issued.

(c) The company having agreed to purchase the shares for $10,000 cash, raises the money by using the 5,000 shares at $1 premium.

(d) The Company offers the respective shareholders the choice of a share for share exchange or $2.00 cash for each share held.

On the basis of *Henry Head* the shares should be brought into the books of the company at $10,000 in each of (a), (b), (c) and (d). Under a restrictive interpretation of that case and of section 64 the value of the shares in books of the company in (a) and (c) would be $10,000, in (b) $5000 and in (d) somewhere between the two depending on the whim of the vendor shareholders.

It is accordingly submitted that assets acquired in exchange for shares should, in accordance with sound accounting practice,[39] *Henry Head* and a normal reading of section 64, be brought in at their proper value and a share premium account created for the excess of such value over the normal value of the shares issued. Once a share premium account is required a distribution of pre-acquisition profits, being a return of the purchase price, amounts to a return of capital in part at least although possibly a part may be capital profit.

A counter argument is that a company may declare dividends out of current income notwithstanding that the value of the capital assets of the company has fallen even to the extent that the net asset value of the shares of a company is, or after the dividend will be, below par.[40]

These cases can be distinguished on the ground that they do not deal with dividends out of pre-acquisition profits of a subsidiary which are correctly a return of capital and not current income. However, the cases in which companies did not allow for depreciation of assets,[41] are instances of the courts allowing cash receipts to be treated as definitive of income (except to the extent that losses in circulating capital must be made good).

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39. As noted above the accounting practice is based on the "true and fair view" requirements of sections 153 (1) and 156 (1). The meaning of these words has yet to be pronounced upon by the courts and it is difficult to predict the effect this would have on the present situation. Buckley J. in *Newton* v. *Birmingham Small Arms Co.* [1906] 2 Ch. 378, 387, for instance, said, "The purpose of the balance sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better.". The scope of this dictum is narrowed by *R.* v. *Kylsant* [1932] 1 K.B. 442, C.A. but to what extent it would be applied today is uncertain.

40. See cases referred to in n. 91, ante and also *Bolton* v. *Natal Land and Colonisation Co.* [1892] 2 Ch. 124.

41. *Lee* v. *Neuchatel Asphalte Co.* and *Re Kingston Cotton Mill* (No. 2) supra, n. 91.

A distinction can be drawn, though, between a prohibition on distribution of pre-acquisition "profits" and a requirement that companies provide for depreciation or diminution in market value of fixed assets for these last two steps require a positive step by directors involving an element of judgment and the courts are generally more reluctant to interfere here than to pronounce a straight prohibition. Further, the cases which did not require the companies to make allowance for depreciation have been criticised by the accounting profession[42] so an extension of *Lee* to this situation is not likely. Such extension was not contemplated by Buckley J. in *Henry Head* who reached his decision only reluctantly

> as it fixes an unfortunate kind of rigidity on the structure of the company, having regard to the fact that an account kept under that name, namely the share premium account, can only have anything paid out of it by means of a transaction analogous to a reduction of capital.[43]

Eighth Schedule paragraph 16 (5).

In the case of a holding company-subsidiary relationship there is a further argument against distribution of pre-acquisition profits based on paragraph 16 (5) of the Eighth Schedule to the Companies Act 1955 which reads

> . . . and the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other subsidiary shall not (for that or any other purpose) be treated as aforesaid [i.e. as revenue] so far as they are profits or losses for the period before the date on or as from which the shares were acquired . . .

It is argued that the use of the words "or any other purpose" includes for the purpose of payment of dividends by the holding company. The object of the Eighth Schedule, however, is, it is submitted, to ensure that the company accounts are properly informative, and not to alter the substantive law. Sub-paragraph (5) clarifies sub-paragraph (4) to ensure adequate disclosure and sub-paragraph (4) is applicable only in the abnormal case of a holding company not filing group accounts. Also the sub-paragraph prohibits such profits being dealt with a revenue profits and so it may be possible to treat them as capital profits. It is common for accounting purposes on a take-over to provide that it is to occur on a particular date. Accordingly the words "or as from which" strengthen the accounting nature of the sub-paragraph, for otherwise they could be used to avoid the possible wide effect of the requirement.[44]

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42. See e.g. B.S. Yamey "Aspects of the Law relating to Company Dividends", (1941) 4 M.L.R. 273.
43. *Henry Head & Co. Ltd* v. *Ropner Holdings Ltd* [1952] Ch. 124, 126.
44. The holding company could stipulate a date some time prior to the natural acquisition.

The requirement of paragraph 16 (5) resulted from the recommendation of the Cohen Committee[45] and even here the preamble to the recommendation stated that pre-acquisition profits were not distributable "as a matter of accounting practice" although the recommendation may have been intended to be substantive.

It is accordingly submitted that ,whatever the cryptic words "or otherwise" means, paragraph 16 (5), by itself, does not prohibit the distribution of pre-acquisition reserves. It does, however, show that the legislature regards such profits as special and serves to strengthen the conclusion reached above that they are not distributable. Directors, therefore, would be unwise to declare dividends from such profits as they may be held personally liable.

If, however, a company declares such a dividend, and its directors have received no professional advice against this practice, the directors might be excused from liability under section 468 of the Companies Act.

Practice

There is no known case where pre-acquisition profits have been used for dividend purposes but Sir Thomas Robson, in giving evidence to the Jenkins Committee on behalf of the Institute of Chartered Accountants in England and Wales, did say that in one instance a plan to so use them was abandoned when the company was told that it was illegal.[46]

A survey of the latest annual reports abailable in September 1969 of the 10 leading New Zealand companies[47] showed that in seven cases shares were issued during the latest accounting period and in at least six cases some were issued on the occasion of a take-over. Only one of these six companies (Wright Stephenson Ltd, whose shares in 1968 sold at aproximately 30% above par) did not increase the share premium reserve at the same time. In the seventh case (The New Zealand Insurance Co. Ltd) the reason for the share increase could not be discerned and there was no increase in the share premium account. One of the remaininng three companies did make an issue at a premium on a take-over in the previous year. It therefore appears that the usual practice is to create a share premium account where shares are issued for non-monetary consideration.

The unavailability of pre-acquisition profits for distribution causes most concern where a new holding company, formed for amalgamation purposes, issues its shares in exchange for shares in other companies as happened in *Henry Head*. If in the first year of operations a loss is made on the basis of the above analysis there are no profits to be dis-

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45. *Report of Committee on Company Law Reform,* 1945, Cmnd. 6659, para. 123.
46. *Minutes of the Jenkins Committee* p. 1375 Q. 6399.
47. See n. 15 ante.

tributed even although the subsidiaries may have large reserves which were accumulated before the amalgamation and the shareholders are substantially the same. It is this problem which has led to attempts to etscape the effect of *Henry Head.*

A recent example of the formation of a holding company is that proposed by Union Carbide Australia Ltd.[47a] The new company is to be called Union Carbide Australia and New Zealand Limited and will purchase the shares of Union Carbide New Zealand Pty. Ltd. for cash and the shares of the Australian company by a $1 for $1 share exchange. The 1969 low for the Union Carbide Australia Ltd shares on the Australian stock exchange was $6.25 each and at the time of the announcement the shares were selling at $6.76. It has yet to be seen at what figures the investment in subsidiaries is brought in at.

Although such holding companies are common in the United Kingdom the only recent example in New Zealand is A.B. Consolidated Ltd. formed in 1961, on the amalgamation of Bycroft Ltd. and Aulsebrook & Co. Ltd. There no share premium account was creaated, although both subsidiaries had substantial revenue reserves, because prior to amalgamation, the value of assets of the two companies were adjusted so that the shareholders funds and reserves as at the date of amalgamation equated the issued capital of the holding company.[48]

The first balance sheet for the holding company[49] revealed a capital reserve of £150,000 with a note to the accounts

> The Capital Reserve of A. B. Consolidated Ltd. arises from distributions from Subsidiary Companies from Pre-amalgamation Reserves and is therefore not available for distribution to shareholders by way of dividend.

The "Investment in Subsidiaries" account was not written down by this amount. In 1969 the Capital Reserve was increased by $250,000 to $550,000 with a similar note and again without reduction in "Investment in Subsidiaries" account.

This suggests that the company must regard pre-acquisition profits as not being available for distribution although it does not seem to regard dividends from them as a return of purchase price. It may be that the company has followed the argument based on paragraph 16 (5).

In England a correspondent in *The Accountant*[50] drew attention to a note in the accounts of Unigate Ltd. for 1960 which read

> The book value of the net assets of United Dairies Ltd. and Cow & Gate Ltd at the date of acquisition exceeded the pur-

47a. See *The Dominion,* 1 September 1969.
48. See the Directors' Report in the First Annual Report of A.B. Consolidated Ltd (1962).
49. Prepared as at 31st March 1962.
50. *The Accountant* 17th December 1960, Vol. 143, p. 781.

chase consideration of £23,579,969 by £9,356,692 which is included in revenue reserves.

The correspondent queried why the excess was shown in the revenue reserves. The editor in reply noted that it was established and accepted practice that pre-acquisition profits are frozen but that there was now a large body in the legal and accounting professions who regarded it as "sound and sensible" in the case of a straight-forward merger to treat the book value of the assets acquired as equal to the nominal value of the shares issued and the revenue reserves of the subsidiaries as available for dividend to the extent that the net value of the assets is greater than such nominal value. This view was publicised in the offer documents for the merger of The Northern Assurance Co. Ltd. and The Employers' Liability Assurance Corp. Ltd. and the directors of Unigate followed this precedent in their own merger on the advice of counsel.

It is difficult to see why, as the law stands, there should be any distinction between a straight-forward merger and any other take-over involving a share exchange, nor what real difference the provision in the merger documents makes. A provision in the memorandum of association still does not permit a company to return its capital.[51] Perhaps the documents were framed to provide that the value of the assets being acquired was deemed to be £X, this also being the nominal amount of the share issue but could such valuation be deemed bona fide in every case?

It is clear from this, and from the evidence to the Jenkins Committee[52] that there is a division of opinion as to the law and this is resulting in uncertainty and artificiality which should be removed. To alleviate hardship relaxation of the strict rule is required where a new holding company is formed for amalgamation purposes.

Law Reform

Most of the evidence to the Jenkins Committee supported the proposition that in the general case, dividends from pre-acquisition profits should not be distributable. This is particularly applicable where the shares are purchased for cash for any other rule would endanger the position of the creditor unless he relies on the nominal issued capital only. Even where there is a share for share exchange the creditor may advance money in reliance on the increased value of the company. If a takeover ocurs shortly before a dividend is due to the purchased company's shareholders it is usual to provide for payment of such dividend by that company before the take-over is regarded as formally completed.

51. *Trevor* v. *Whitworth* (1887) 12 App Cas. 409.
52. E.g., evidence of the Institute of Chartered Accountants of Scotland, Minutes of Jenkins Committee p. 1336.

Except with amalgamations a company may "buy profits" in other words, acquire the controlling interest in companies with large liquid assets and reserves and use these to pay large dividends on their own shares thus giving those shares an artificially high market value.[53]

The Jenkins Committee concluded that the law should be clarified by making the prohibition explicit.[54] Practical difficulties arise as to the date of acquisition but the Jenkins Committee recommended[55] that this should be

> no earlier than the close of the latest accounting period ot the acquired company before the contract was entered into.

Provided the accounts were audited this would solve this problem.

The arguments in favour of clarifying section 64 to require a share premium account in all cases where the value of the assets acquired exceeds the nominal value of the shares issued were adopted by the Committee.[56] The Jenkins Committee recommended that there should be an exemption from the general rule for insignificant amounts of pre-acquisition profits and for inter-group acquisition.[57] The inter-group acquisition exemption is based on the existing exemption in paragraph 16 (5) of the Eighth Schedule and appears reasonable since otherwise profits may be lost to the group on the rationalisation of its affairs. The exemption is sufficiently wide to avoid this result.[58]

The major problem is that of amalgamations and the rigidity which results from the general rule. Where one company acquires all the shares in another company it is in some respects a successor to that other company. The Committee on Shares of No Par Value[59] recommended that where there was no substantial change in the ownership on the reconstruction or amalgamation (defined to be when 90% of the shareholding in a subsidiary is acquired) the revenue reserves which existed before the reconstruction or amalgamation should not be frozen. Taken literally this would be too wide as it may not prohibit distribution of all the revenue reserves even if they exceed the share premium account.

The Jenkins Committee[60] felt that this recommendation did not prohibit the buying of profits nor did they feel that any real hardship arose in the ordinary take-over or amalgamation since the holding com-

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53. Jenkins Report para. 345.
54. Ibid., para. 350 (d).
55. Ibid., para 350 (e).
56. Ibid., para. 187 (c).
57. Ibid., para. 350 (f).
58. However, Guest, Keen & Nettlefolds Ltd in evidence to the Jenkins Committee did not consider this to be so, Minutes of Jenkins Committee p. 137.
59. *Report of Committee on Shares of No-Par Value* (Gedge Committee) 1954, Cmnd. 9112, para 72 (10).
60. Jenkins Report para. 345.

pany had its existing reserves.[61] It accordingly recommended[62] that where a *new* holding company was formed and it acquired 90% or more of the issued shares of one or more companies it should be permitted to distribute the pre-acquisition profits of one only of the acquired companies but such distribution is not to exceed the amount of the premium on the shares issued. This premium is to be transferred to an account other than the share premium account and is to be used in writing down the investment in the subsidiary when and to the extent that dividends are received from that company from pre-acquisition reserves. The holding company must elect to take advantage of this exception prior to the publication of the first balance sheet which does provide creditors and others with notice as soon as reasonably possible. Power for the company to apply to the court in the case of hardship was also recommended[63] but this power is virtually nothing less than a reduction of capital under another name.

Generally the committee's recommendations are sound but they are somewhat restrictive when permitting the exception in relation to only one subsidiary.

The recommendations do not completely prevent the buying of profits—the purchaser could form a new company to acquire the subsidiary and holding company but this is rather a cumbersome method and this may be sufficient to deter speculators.

Another approach was proposed by Weinberg.[64] He agreed that section 64 should be clarified but advocated that where in a share for share exchange a share premium account results it is to be regarded as permanently capitalised to the extent that the nominal value of the shares issued is less than the nominal amount of the shares acquired (to prevent "unauthorised reductions in capital") and the balance of the account is to be regarded as "conditionally capitalised".[65]

When dividends are received from a subsidiary[66] they may be distributed by the holding company if simultaneously an amount equal to the distribution by the *holding* company is written off both the "conditionally capitalised" part of the share premium account and the investment in subsidiary. However, the better accounting practice would be to write down the investment in the subsidiary by the total amount of the dividend received from the subsidiary and to permit the distribution of the "conditionally capitalised" share premium account up to the amount received. This is the effect of the Jenkins Committee proposals. These provisions are not limited to 100% acquisitions and are also applicable if the shares are acquired for cash raised from

61. This may not necessarily be the case in all circumstances.
62. Supra para. 350 (g).
63. Ibid., para. 350 (h).
64. Weinberg, *Take-Overs and Amalgamations* (2nd ed. 1967) paras. 1928-1931.
65. Surely a completely separate account with a distinct name would be better. This would be less confusing and would give creditors notice.
66. Weinberg's discussion is limited to subsidiaries.

issuing shares to existing shareholders or if the shares are acquired partly by this means and partly by share exchanges.

These provisions extend wider than is necessary to alleviate most cases of hardship and make buying of profits easier than under the Jenkins Committee Recommendations. The general rule should be departed from only to avoid hardship. The proposal to prevent unauthorised reductions of capital is good and should be incorporated into the Jenkins Committee reforms. If, however, there are more shares issued than acquired the apparent increase in capital can be avoided under Mr Weinberg's proposals by placing a higher value on the shares acquired than is revealed in the books of the subsidiary and increasing the "conditionally capitalised" portion of the share premium account accordingly. This is akin to a surplus arising on revaluation of fixed assets and should not be distributable.

To avoid this Pennington in a review of the first edition of Weinberg's book[67] and reiterated by Pennington in *The Investor and the Law*[68] suggested constructing a consolidated balance sheet at the date of acquisition and creating reserves available for distribution on the basis of this. This purpose is again wider than necessary to alleviate hardship and does not prevent the buying of profits. Also, unlike Weinberg's proposals, it does not prohibit unauthorised reductions of capital. Such a proposal would be difficult to work in practice when there is a series of take-overs and especially where these do not take place at balance date. If his proposal were adopted special balances should be required on each take-over and perhaps capitalisation on true values. The proposals would mean making the share premium account distributable in part, for, upon consolidation on proper accounting lines, pre-acquisition profits are eliminated which would leave only what was already distributable together with the share premium account.

It is therefore submitted in conclusion that the Jenkins Committee proposals are to be preferred and are the most workable but that these proposals should be extended to more than one subsidiary and should provide against unauthorised reductions in capital.

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67. (1964) 27 M.L.R. 104, 106.
68. *The Investor and the Law,* London, 1968, 598.

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