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The Dominion of Canada Companies Act, 1935

By A Canadian Correspondent

The Canadian companies act of 1935 is a short one and is a further step forward. Its leading feature from the investors' standpoint is the repeal of subsection 9 of section 12, which made it possible to transfer to "distributable surplus" twenty-five per cent. of what was really the capital contributed for shares of no par value, and to use it for dividends or in any other way in which properly made profits could be used, even though that capital had been contributed many years previously. The fact that the original shareholders probably thought that they were contributing the permanent capital of the concern hardly weighed at all. This so-called "distributable surplus" could be built up from common share capital and paid away in dividends to preferred shareholders, even if the profits earned from the ordinary operations were nil. Parliament has realized the possibilities of this, and has cancelled it. It is a good thing that the department of the secretary of state for Canada, which could veto proposed transfers, was and is usually very efficient, wide-awake and strong, but even the best of departments can make mistakes and allow questionable transactions to slip by.

However, it is still possible to issue shares of no par value so that twenty-five per cent. of the consideration can be transferred to "distributable surplus." This term is a bad one, because surplus usually results from an accumulation of profits, and both capital and earned (or revenue) surplus are distributable in proper circumstances. "Contributed surplus" or "paid-in surplus" would have been a more accurate description; but it looks as if the legislators who used the phrase in the 1930 act intended to make it quite clear that such surplus could be paid away in cash dividends. The danger of this power to issue such shares lies in that it makes it possible for a company to pay cash dividends, even though it has not earned a cent of profit. There could be no objection to it, if it were only possible to issue shares in this way, provided that the company had been in existence and carrying on operations for a number of years, and provided that it was earning profits above the usual rate of interest, so that it was justified in issuing shares at a premium, because this "distributable surplus"

is really only a form of premium. As it is, companies can issue such shares at their first issue and many do so, even though there can not possibly be any accounting justification for such a premium. Nothing can operate before it exists. How, then, can a company show that it is earning profits at a high rate before it has carried out any operations whatever? As we all know, the payment of cash dividends is often taken as a sign of a good concern by the unwary and the ignorant, and accordingly there is danger that companies may be created with little intention of earning real profits from their operations, but of paying dividends out of "distributable surplus," so that the public, unwitting as to the real source of these dividends, is willing to pay high prices for such shares, only to find when it is too late that it has paid heavily for shares in a losing concern, which has paid away twenty-five per cent. of the money contributed for its shares. The only safeguard which investors have is to examine carefully the "statutory information" in the prospectus for an issue of shares required from every company registered under the Canadian dominion act; and, if they see that a portion of the consideration is to be transferred to "distributable surplus" with no proper justification, to avoid taking up the shares of that company.

In addition to cases in which companies have shown that they are earning profits, it may be used, justifiably, when a holding company acquires all of the shares of another company, immediately at the close of a financial period, and accordingly before it has been possible to ascertain and distribute the profits made in that period by the company which is being taken over. In such cases, however, it is not essential, because the date of sale can be postponed a few weeks until the profits of the period just closed have been ascertained and the necessary dividends declared. If this is done, the profits earned by the subsidiary between the close of the period and the date of sale would have to be capitalized by the holding company, but that is all, and it would inflict little hardship. Again, this could be avoided by making it possible to wait until the profits of the subsidiary for the period just closed had been ascertained and the dividends declared, and then to arrange the sales contract, but to ante-date the transfer to the close of the period, and to exclude from the assets taken over by the holding company the cash representing the profits made and to be distributed by way of dividends. I, however, prefer the method which calls for the capitalization of profits made by the subsidiary

between the close of the financial period and the date of the sale-transfer. Properly it would call for a closing-off of the subsidiary's books a few weeks after the close of the period, but that need not be an overwhelming problem, and it would not occur again.

The "statutory information," which Canadian dominion company law requires to be published in prospectuses, is full and very informative. In this respect the Canadian dominion company law could well be studied as a model.

An excellent subsection has replaced the original section 12, subsection 9. It provides that,

> "Shares in the capital stock of the company having a nominal or par value shall not be issued as fully paid except for a consideration payable in cash to the total nominal amount of the shares so issued, or for a consideration payable in property or services which the directors may determine by express resolution to be in all the circumstances of the transaction the fair equivalent of cash to the total nominal amount of the shares so issued:"

It goes on to provide that the directors may make application to a judge to give his opinion as to the fair value of consideration, where it consists of property or services. Evidently, in future liquidations, where there is a question as to the value of the "services" rendered by certain persons for the issuance of shares to them, and directors have not previously asked for a declaration from a judge, the said directors are going to be asked why they failed to do so. People who obtain "fully-paid" shares on the strength of supposed "services" to a company, which subsequently becomes bankrupt, may find themselves in the lists of contributories, as persons who have not yet fully paid for their shares. The directors who consented to the issue, also, are liable for the amount, "less than the fair equivalent in cash."

Subsection 10 of section 12 hits at non-voting shares. It provides that,

> "In no case shall shares of a public company of any class or any subdivision of any class, whether with or without par value, be issued and allotted to which shall attach any exclusive right to control the management of the business or affairs of the company by the election or removal of the board of directors thereof or otherwise."

This will not affect preferred shares with preferential voting rights which may be exercised in a stated event only.

There is much stringent legislation against directors in this act. For example, every director must now furnish annually to his company's secretary, for the information of its shareholders, a detailed statement of the shares and securities of the company bought and sold by him during the previous twelve months. Directors are forbidden to speculate for their personal accounts in the shares of their companies; although exactly how "speculation" is to be proved is not very clear, and probably only very flagrant cases could be prosecuted. Fines and imprisonment are the penalties for such speculation or for false declarations as to transactions in the company's shares and securities.

The annual statements come in for further legislation. Debts which are collectible and those which are not, or are very doubtful, must be shown separately, unless provision is made for the bad and doubtful, or "non-current," debts, as the act puts it. If land, buildings or plant has been written up in the books so that a surplus has resulted, the amount by which any of these items has been written up during the three previous years must be stated on the balance-sheet. In the revenue statements, the remuneration of the directors, as directors (not as managers or otherwise), must be shown separately, no matter whether it is called directors' fees, commission or is described in any other fashion. The same applies to the remuneration of counsel, solicitors and legal advisors of the company. Canadian operating statements and balance-sheets prepared under the dominion law are now full of valuable information.

On the whole, the act is a distinct attempt to be more strict, although it is a little difficult to see how certain things are to be proved. In any case its provisions will certainly be beneficial.