## PAYMENT OF DIVIDENDS OUT OF CAPITAL.

(An Interesting Welsh Banking Case.)

It is well known to every person familiar with Canadian banking matters that, if those institutions which have unfortunately come to grief in Canada, as, for instance, the Consolidated, Exchange, Maritime, Central, London and others, had avoided giving excessive discounts or credits to some of their customers, they would in nearly every case be in existence today. The rock or shoal on which they have all been wrecked is that of staking too large a portion of their assets on the credit of one man or firm. Many remedies have been proposed for this state of affairs. In some quarters, a system of Government inspection has been talked as the panacea, but all experienced bankers know that a complete and thorough examination of a Canadian chartered bank's assets and liabilities would be almost impossible, and any examination which would be only superficial and perfunctory would be undesirable in the highest degree. Some years ago, a very simple and easily enforced regulation was proposed—the passage by Parliament of a law prohibiting any bank from advancing more than ten per cent. of its paid-up capital either directly or indirectly to any one firm, company, or business enterprise; any credits given to any individuals or employees of a firm to be included with the advances to the firm itself. It was further suggested that if the directors of a bank, either knowingly or through negligence, allowed this law to be evaded, they should be held jointly and severally liable for any loss which might occur on the amount of credit allowed beyond the limit of ten per cent. of the capital. Although there is no reason to suppose from scrutiny of the sworn statements submitted to the Government that any of our banks deviate sufficiently from sound banking principles to treat and value bad and doubtful debts as good assets, and to pay dividends, and make additions to reserve funds without first making adequate provision for possible and probable losses, there is an object lesson in the following story of the National Bank of Wales calculated to impress itself upon the mind of any weak bank manager, and even to penetrate the understanding of neglectful directors who may foolishly imagine, like Mr. John Cory, that, when the day of reckoning arrives, a plea of ignorance of their duties and responsibilities will relieve them of liability for what Mr. Justice Wright regards as fraudulent folly.

The principle, that payment of dividends out of the annual profits, when no allowance is made for numerous and increasing bad debts, amounts to a payment of dividends out of capital, has been laid down by the judge already named, recently in England, in proceeding taken by the liquidator of a defunct bank against one of the Directors. The National Bank of Wales was incorporated in 1879, and went into liquidation in 1893. The principal cause of failure was the absorption at the end of 1890 of an insolvent banking undertaking. Another cause was the fact that advances were foolishly made without proper security, and were treated from year to year as good assets, after they had become bad. Two of the directors and the general manager were sentenced to penal servitude for fraud, another surrendered all his property to the liquidator, and another was insolvent. The matter in question was, to what extent another director, John Cory, ought to be held responsible for the disaster. The liquidator had sold all the assets of the bank, including the right to make calls, and the right to take proceedings, to another company for a considerable sum, which had been used in paying the creditors. The proceedings against the Director, Mr. Cory, were therefore really for the benefit of the concern which had purchased the assets. In the course of his judgment the learned judge said:—In the annual balance sheets, the book debts due to the bank are treated and valued as good assets, which were in fact bad debts. It does not require expert evidence to show, that it must be an essential part of sound banking to make in some way an adequate provision for bad or doubtful debts. If such provision is not made, capital must be lost, and dividends paid must be regarded as paid out of capital, because there is no other fund except borrowed money from which they can be paid. In the years which were in question, it appeared that the annual increase of bad debts was such that it would have absorbed the entire net profits of those years. It is plain, that assuming the facts to have been known to the directors, they ought, in view of the large amount and great and continual progressive increase of the bad and doubtful debts, to have made provision for them out of profits to an amount in each year representing the average or normal rate of increase. In paying dividends without having made such adequate provision, they were *pro tanto* dividing money which was required for replacing capital lent to customers, who could not repay it. Bad debts must be treated as bad debts of the year in which they become or are known to be bad. A reserve fund is a fund set apart to meet contingencies, after due provision is made for all bad and doubtful debts, and cannot be regarded as a substitute for a provision which should be made for bad debts. The defence of the director was, that he knew nothing of what was going on, but trusted the general manager and the chairman who was his brother.

In considering how far a knowledge of these matters should be imputed to the director, the judge said:—He was a paid director. He was a man of business, of great local influence and position, a director of other important local companies, and his name was a mainstay of the bank's credit. He attended board meetings with regularity. He held himself out as taking an active part in the management. He was a large shareholders and depositor. The customers of the bank were persons with whom he had grown up, and many of the largest accounts were those of his relations or colleagues. He must have known the necessity of providing for bad debts in such a business,