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MAY NEBRASKA CORPORATIONS PAY A DIVIDEND FROM SURPLUS INCLUDING UNREALIZED APPRECIATION FROM REVALUATION OF FIXED ASSETS

The problem with which this note is concerned is whether under Nebraska law a corporation may pay a dividend from a surplus created, or at least enhanced, by a revaluation of fixed assets. The Nebraska Supreme Court has not decided the issue. In an attempt to answer this question the following must be considered: first, an examination of Nebraska's statute and what it means; second, a survey of some representative types of state statutes and the cases decided under them; and third, the effect of policy considerations which any court must weigh when confronted with the problem.

I. The Nebraska Statute

Section 21-175 of the Nebraska statutes sets out the funds which may be distributed as dividends:

The directors of every corporation operating or organized under this act, subject to any restrictions contained in its articles of incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (1) out of its net assets in excess of its capital stock as computed in accordance with the provisions of sections 21-129, 21-130, 21-151, 21-153, 21-154 and 21-161, or (2) in case there shall be no such excess, out of its net profits for the fiscal year then current or the current and preceding fiscal year; *Provided*, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired.¹

The instant problem encompasses only the first provision, that is, dividend payments out of a "surplus" of net assets over capital; nevertheless, the statute is set out in its entirety to illustrate that Nebraska provides for dividend payments out of either surplus or profits, a point which will be discussed during the survey of the various types of state statutes.

The immediate questions are what constitute "net assets" and "capital"? According to the plain meaning of the statute, dividends may be paid out of the excess of net assets over capital.

¹ Neb. Rev. Stat. § 21-175 (Reissue 1954).

Net assets are ascertained by subtracting the liabilities of the corporation from its total assets.² Capital is computed in accordance with the sections cited by the statute, and, for purposes of the present problem, it is important to note that capital equals the amount of the par value of the paid-up issued shares of stock.³ The formula thus becomes: total assets minus liabilities equals net assets minus capital equal surplus from which dividends may be paid.

The problem of payment of dividends from surplus enhanced by revaluation of fixed assets concerns the first item, i.e. total assets. In other words, for dividend purposes may be fixed assets, a segment of total assets, reflect an unrealized appreciation in value thus increasing total assets, or must they be evaluated at cost?

The surplus account of a corporation can arise from one or more of several sources; it may be "earned surplus" such as where it is derived wholly from undistributed profits; it may be "paid-in surplus" when the stock is issued at a price above par, or it may, among other things, represent the increase in valuation of land or other assets made upon a revaluation of the fixed assets.⁴ The several states are not in accord as to whether any or all of the above sources may be utilized for the payment of dividends.

No case has arisen in Nebraska under Section 21-175, and, prior to its enactment, only two cases were decided which in any way touched on the question of dividend payments from a fund reflecting revalued fixed assets.⁵ Therefore, a survey of the various state statutes, and the decisions construing them, compared to Section 21-175, may be helpful to determine how the question will be decided in Nebraska.

II. Survey of State Statutes

Two basic historical theories were developed to control the right of a corporation to pay dividends.⁶ One theory permitted a corporation to pay dividends from surplus so long as the capital was not impaired. The second theory allowed a dividend payment only from the profits of the corporation. These methods have

² Dohr, Thompson and Warren, *Accounting and The Law* 69 (1952).

³ Neb. Rev. Stat. § 21-129 (Reissue 1954).

⁴ *Winkelman v. General Motors Corporation*, 44 F. Supp. 960 (S.D.N.Y. 1942); *United North and South Development Co. v. Heath* 78 S.W.2d 650, 651 (Tex. Civ. App. 1934).

⁵ *Splittgerber Bros. v. Skinner Packing Co.*, 119 Neb. 259, 228 N.W. 531 (1930); *Corliss v. United States*, 7 F.2d 455 (8th Cir. 1925).

⁶ Kehl, *Corporate Dividends* 4 (1st ed. 1941).

been modified greatly and some statutes, including Nebraska's, now permit the use of both surplus and profits—if the preferred stock is not impaired—for the payment of dividends.⁷

Statutes governing dividend payments range from strict to liberal in their provisions with Nebraska's seemingly in the latter category.⁸ Examples of the more restrictive statutes are those of Illinois, Michigan and Pennsylvania. These statutes provide for dividend payments out of surplus. However, all three states have declared that paying dividends from unrealized profits is unsound.⁹

A case arising under the Pennsylvania statute is *Berles Broadcasting Co. v. Craumer*.¹⁰ In this case a corporation attempted to pay dividends from a surplus created by a revaluation of fixed assets which resulted in an increase of \$26,000 over the original cost. The court, in holding the dividend illegal, stated:

The surplus out of which dividends may be declared and paid must be bona fide and founded upon the actual earnings or profits, and not dependent on a theoretical estimate of an appreciation in the value of the company's assets.¹¹

New York, adopting a liberal approach similar to Nebraska's statute, employs the impairment of capital test. The statute provides:

No corporation shall declare or pay any dividend which shall impair its capital or capital stock, nor while its capital stock is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number or par value of its shares or of its capital, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital.¹²

An interpretation of this provision could serve as an analogy for the Nebraska courts since the wording of the New York statute is similar to Nebraska's provision. New York requires that

⁷ Del. Code Ann. tit. 8, § 170 (1953); Neb. Rev. Stat. § 21-175 (Re-issue 1954); N.J. Stat. Ann. § 14:8 to § 14:20 (1939); Nev. Comp. Laws § 1625 (1929).

⁸ The basis for the statement that Nebraska's statute is seemingly in the liberal category is that the statute provides for dividend payments out of both surplus and profits under certain conditions. Thus, it incorporates both historical approaches to this practice.

⁹ Ill. Ann. Stat. c. 32, § 157.41(c) (1954); Mich. Stat. Ann. § 21.22 (Supp. 1953); Pa. Stat. Ann. tit. 15, § 2852-701(1) (1938).

¹⁰ 356 Pa. 620, 52 A.2d 571 (1947).

¹¹ Id. at 624.

¹² N.Y. Corp. Law § 58.

after a dividend payment is made the remaining assets must have a value equal to the total of liabilities plus capital. Nebraska requires that before a dividend can be paid there must be a surplus of assets over the total liabilities plus capital. Thus, neither state permits a dividend to be paid if its effect is to diminish net assets to an amount which will impair capital nor to pay such a dividend while capital is impaired. However, it must be emphasized that the New York statute speaks of assets in terms of value; but it does not indicate whether "value" means the value of the assets at the time of their acquisition or the value of the assets on the date the dividend is declared. The Nebraska statute speaks only of assets and presents the same problem of when they are to be evaluated for dividend purposes.

Despite the distinction in terminology, a very important case to consider is the New York case of *Randall v. Bailey*.¹³ In this case it was held that unrealized appreciation in fixed assets could be taken into consideration in determining whether there existed a surplus out of which dividends could be paid.¹⁴ The court stated:

Under a statute providing that dividends can be paid when there is no impairment of capital or capital stock caused thereby, and when the value of the corporate assets remaining after such payment equals the aggregate amount of the corporation's debts and liabilities, including capital or capital stock, or, in other words, from surplus, such "surplus" could consist of increases resulting from revaluation of the fixed assets of the corporation, such as its land.¹⁵

However, the *Randall* case does not completely solve the Nebraska problem of payment of dividends from a surplus of unrealized appreciation since the court treated the issue as a question of statutory construction instead of a question of sound economics, sound business judgment or proper accounting practice. In determining legislative intent the court found that for nearly one hundred years the New York statute restricted the sources of

¹³ 23 N.Y.S.2d 173 (Sup. Ct. 1940), aff'd, 288 N.Y. 280, 43 N.E.2d 43 (1942).

¹⁴ The court held also that unrealized depreciation must be taken into consideration and must therefore be deducted from surplus to determine the amount available for payment of dividends. Justice Walter stated, "I am of the opinion that the same reasons which show that unrealized appreciation must be considered are equally cogent in showing that unrealized depreciation likewise must be considered. In other words, the test being whether or not the value of the assets exceeds the debts and the liability to stockholders, all assets must be taken at their actual value." *Randall v. Bailey*, 23 N.Y.S.2d 173, 184 (Sup. Ct. 1940), aff'd, 288 N.Y. 280, 43 N.E.2d 43 (1942).

¹⁵ *Id.* at 182.

dividend payments to "surplus profits arising from the business," to "surplus profits of its business" and, finally, to "surplus." However, when the statute was amended, these phrases were not included. Because of this omission, the court argued that the legislature did not intend to restrict the payment of dividends to "surplus" and "surplus profits."¹⁶

So, while the *Randall* decision correctly construed the legislative intent of the New York statute, the decision would carry little persuasive force in the Nebraska courts if there were a contrary intent underlying Section 21-175.

Nebraska's General Corporation Law was drafted by the Corporation Law Sub-Committee of the Nebraska State Bar Association and was passed by the 1941 Nebraska Legislature. Prior to 1941 there was no provision in the Nebraska Statutes in regard to the payment of dividends; therefore, it is impossible to employ the technique of comparing an existing statute with the new statute to determine legislative intent. In addition, the notes, memoranda and other studies compiled and utilized by the Sub-Committee of the Nebraska State Bar Association which drafted the Corporation Law¹⁷ have since been lost or destroyed.

It is important to note, however, that in the case of *Splittgerber Bros. v. Skinner Packing Co.*,¹⁸ the Nebraska court held that not only was it permissible to pay a dividend out of a surplus enhanced by a revaluation of land, but also that if the corporation's assets were honestly valued at the time of declaration, a dividend was not unlawful because the assets subsequently proved to be worth less than the valuation. Unless the present statute abrogates this decision, the case, decided prior to 1941, would serve as precedent for allowing a dividend to be paid from a fund reflecting increased valuation of fixed assets.

Thus the question is whether the *Splittgerber* decision was changed by the adoption of Section 21-175 in 1941. Section 21-175 was borrowed from the Delaware statutes. In *Morris v. Standard Gas and Electric Co.*¹⁹ the Delaware court construed its statute. It held that net assets were to be valued at present (date of declaration) value for dividend purposes. The case involved a payment of dividends from profits so it is not directly in point for the instant problem. Nevertheless, the court held not only

¹⁶ Id. at 178-180

¹⁷ Ritchie, General Corporation Law of Nebraska, 21 Neb. L. Rev. 197, 199 (1942).

¹⁸ 119 Neb. 259, 228 N.W. 531 (1930).

¹⁹ 63 A.2d 577 (Del. 1949).

that the directors were to ascertain the present value of assets for dividend purposes, but also that this valuation by the directors could not be disturbed by the court where there was no charge of fraud or bad faith.²⁰ As it is impossible to ascertain the legislative intent underlying the Nebraska statute, this case, decided under the parent statute of Section 21-175, stands as the best indication of the way in which the Nebraska court will interpret the Nebraska statute.

On the basis of the Delaware case of *Morris v. Standard Gas and Electric Co.*, decided under the statute from which Nebraska borrowed its statute, the New York case of *Randall v. Bailey*, decided under a statute very similar to the Nebraska statute, and the Nebraska case of *Splittgerber Bros. v. Skinner Packing Co.*, which seemingly has not been affected by the adoption of the present Nebraska statute, it would appear that a dividend could be paid from revaluation surplus.²¹

III. Policy Considerations

The policy considerations which should be weighed when making a dividend payment from surplus including unrealized appreciation do not lend support to the above result. The fact that such a dividend would probably be held legal in Nebraska does not mean that such a practice is in keeping with good accounting or economic principles. Writing up fixed assets is considered unsound business practice by accountants. Such items are entered, carried, and retired at cost, notwithstanding the gross discrepancies between cost and current value which may exist.²² Also, there is a slight trend in the law to follow generally accepted accounting principles as is evidenced by the 1954 Internal Revenue Code.²³ This should serve as a reason for the courts to consider seriously the policy reasons underlying these accounting principles.

²⁰ *Id.* at 585.

²¹ Such a result is not without support from other jurisdictions. *Edwards v. Douglas*, 269 U.S. 204 (1925); *Siegman v. Electric Vehicle Co.*, 140 Fed. 117 (3d Cir. 1905); *Cannon v. Wiscasset Mills Co.*, 195 N.C. 119, 141 S.E. 344 (1928); *Cox v. Leahy*, 204 N.Y. Supp. 741 (Sup. Ct. 1924); *Hyams v. Old Dominion Copper Mining and Smelting Co.*, 82 N.J. Eq. 705, 89 Atl. 37 (Ch. 1913), *aff'd*, 83 N.J. Eq. 705, 92 Atl. 588 (Ct. Err. & App. 1914). But see *Sexton v. Percival Co.*, 189 Iowa 586, 177 N.W. 83 (1920); *Southern Cal. Home Builders v. Young*, 45 Cal. App. 679, 188 Pac. 586 (1920).

²² A.I.A. Res. Bull. No. 33 (1947).

²³ Prior to the 1954 Code an accrual basis taxpayer was not permitted to defer income already received to the period in which it would be earned, nor was he permitted to allow for contingent losses which would probably be occasioned in a subsequent period. Prior to the 1939 Code, he was

From an economic standpoint the conclusion that dividends may legally be paid from revaluation surplus is a paradox. The directors, without incurring liability, could force a corporation into involuntary dissolution by paying out all the working capital as dividends while keeping on hand enough other assets to cover the total of liabilities plus capital. Thus, the corporation would become equitably insolvent²⁴ while still maintaining the required legal equation that net assets (assets minus liabilities) equal capital. Creditors unpaid as a result of such a situation could, of course, sue to judgment and attach or levy upon the assets of the corporation. However, such an argument seems to force unnecessary litigation which might be avoided by not permitting dividend payments out of a surplus created by revaluation of fixed assets.

A major problem which arises when a corporation wishes to revalue its assets is the criterion to be used in ascertaining present value. It is almost impossible to determine what relative weight should be awarded to the various factors in valuation: original cost, reproduction cost, similar sales, tax assessments, earning capacity, or insurance valuations. Also, as evidenced by the *Morris* case, the value reached by the directors will not be disturbed by the court in the absence of a charge of fraud or bad faith. Thus, the shareholders and creditors are subjected to the double uncertainty of fluctuating market values and directors' speculations.

Acknowledging that it is nearly impossible to ascertain legislative intent in this instance, the court should therefore weigh the evils of the double uncertainty of fluctuating market values and directors' speculations against any possible good which may result from permitting dividend payments from surplus including unrealized appreciation in the value of fixed assets and use the result as a determining factor of the legality of such a dividend.

not permitted to make allowances for debts which were not completely worthless. Now, under the 1954 Code, §§ 452, 461, 462, reserves for bad debts and contingent losses as well as the deferral of income until the period in which it is earned are permitted with the safeguards that they are made "in the discretion of the Secretary" and that he be "satisfied" that the estimates can be made with "reasonable accuracy." Note, 34 Neb. L. Rev. 116 (1954).

²⁴ The distinction between "legal" insolvency and "equitable" insolvency is that a corporation is equitably insolvent when it cannot meet its current liabilities as they mature. It is legally insolvent when it does not have sufficient assets to pay its liabilities. See Weiner, Theory of Anglo-American Dividend Law, 29 Col. L. Rev. 461, 465 (1929).

Conclusion

Unless the Nebraska court is willing to depart from the precedent of the decision of the *Morris* case rendered under Nebraska's parent statute, disregard the probative force of the *Randall* case, and overrule its previous decision in the *Spittgerber* case, a dividend payment out of a surplus created or enhanced by a revaluation of fixed assets would probably be legal in Nebraska.²⁵ However, if the court gives weight to the relative importance of the policy considerations involved, it could find sufficient support for a different holding.

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