UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 8 | Number 1 Article 5

12-1-1929

Profits, Surplus and the Payment of Dividends

C. B. Sparger

PROFITS, SURPLUS AND THE PAYMENT OF DIVIDENDS

C. B. SPARGER*

The North Carolina statute[1] puts three limitations upon the payment of dividends: (1) They must be paid from surplus or net profits arising from the business; (2) They may not be paid when the corporation's debts, whether due or not, exceed two-thirds of its assets; (3) The capital stock may not be distributed to the stockholders, except as provided by statute. Directors who violate the provisions of the act are held jointly and severally liable for the full amount of the dividend.[2] Thus the common law liability of directors[3] for the wrongful payment of dividends has been altered and increased.[4] The legislature makes no attempt to define what

* Member of North Carolina Bar and Certified Public Accountant (North Carolina). Formerly Assistant Professor of Accounting, University of North Carolina.

[1] §1179 of N. C. Cons. Stat. Ann (1919) provides the following: "No corporation may declare and pay dividends except from surplus or net profits arising from its business, or when its debts, whether due or not, exceed two-thirds of its assets, nor may it reduce, divide, withdraw, or in any way pay any stockholder any part of its capital stock except according to this chapter. . . . In case of a violation of any provision of this section, the directors under whose administration the same occurs are jointly and severally liable, at any time within six years after paying such dividends, to the corporation and its creditors, in the event of its dissolution or insolvency to the full amount of the dividend paid, or capital stock reduced, divided, withdrawn, or paid out, with interest on the same from the time such liability accrued. Any director who was absent when the violation occurred or who dissented from the act or resolution by which it was effected, may exonerate himself from such liability by causing his dissent to be entered at large on the minutes of the directors at the time the action was taken or immediately after he has had notice of it."

[2] Claypoole, Trustee v. McIntosh et. al. 182 N. C. 109, 108 S. E. 433 (1921); Note 1, *Supra.*

[3] 14(a) C. J. 190 par. 1971. If the directors act in good faith, and without negligence, they are not liable to creditors, at common law, for having declared and paid dividends, when they should not have done so, and thereby diminished the capital stock. Moore v. Murchison 226 Fed. 679 (C. C. A. 4th. 1915); Davenport v. Lines, 77 Conn. 473, 59 Atl. 603 (1905); but if the directors have been guilty of a fraudulent breach of trust or of gross negligence, in paying dividends when they had no right to pay them, they are personally liable to creditors or to a representative of the corporation suing in their behalf. Coleman v. Booth, 268 Mo. 64, 186 S. W. 1021 (1916); Fell v. Pitts, 263 Pa. 314, 106 Atl. 574 (1919).

[4] See Comment, "The Statutory Responsibilities for Payment of Dividends Out of Capital," (1926) 35 YALE L. JOUR. The discussion considers four classes of statutory responsibility.

1. Upon directors who "knowingly" declare and pay such dividends.
2. Upon directors "assenting to" them.

is meant by "Surplus," "Net Profits," "Assets," or "Capital Stock." This task is left entirely to the courts.

In the recent North Carolina case of *Cannon v. Wiscassett Mills Co.*,[5] there was an application for a writ of mandamus to compel the directors to pay a dividend equal to the accumulated surplus of the corporation, less the amount set aside for working capital.[6] The court said: "In order to determine the amount of the accumulated profits available for dividends, assuming the said values are correct for that purpose, there should be deducted from said sum the capital stock, the working capital, and all other liabilities of the corporation." Quoting from 14 Corpus Juris 802, the following definition is given by the court, "The terms 'net profits' or 'surplus profits' have been defined as what remains after deduction from the present value of all the assets of a corporation the amount of all the liabilities, including capital stock." The court continues, "Manifestly, for the purpose of determining the amount to be declared and paid as a dividend, it is necessary that the true value of the assets, in cash, and not the mere book value, should be ascertained, for no dividends can be lawfully declared and paid except from surplus or net profits of the business." The court no doubt meant the cash value of the business as a going concern, and not what the various assets would sell for in case of liquidation.

For purposes of valuation, R. B. Kester, Professor of Accounting at Columbia University, divided assets into three groups: (1) Current assets which should be valued on the basis of cash realizable value. (2) Deferred charges whose valuation involves merely the equitable prorating between fiscal periods. (3) Fixed assets which are valued on the basis of cost less depreciation due to the portion used up in operations to date.[7]

In the Cannon case the plaintiff accepted the assets, shown in a statement prepared under the authority of the directors, as being correct, but contested certain items shown as liabilities and the amount of the surplus. The reserve for depreciation of plant and equipment

3. Upon directors who "vote for" or "declare" them.
4. Upon directors under whose administration such dividends were declared.
[5] 195 N. C. 119, 141 S. E. 344 (1928), Held the mandamus should be granted in accordance with the method laid down by the court for determining net profits and surplus.
[6] For a discussion of a similar problem see Dodge v. Ford Motor Co., 204 Mich. 459, 170 N. W. 668 (1919); (1919) 17 MICH. L. REV. 502; (1919) 28 YALE L. J. 710.
[7] KESTER: ACCOUNTING, THEORY AND PRACTICE, Vol. II, page 123.

was shown on the balance sheet as a liability. The trial court took no account of this item in determining the corporation's surplus. This was an error. Reserve for depreciation is not a liability, but it should be shown as a deduction from the plant and equipment accounts in order to determine their value. Since the figure given for the reserve was attacked by the plaintiffs the burden should be upon them to prove that the amount shown was incorrect, but it does not follow that every other item on the statement should be presumed to be incorrect, and the burden thereby put upon the plaintiff stockholders to prove their correctness. Unless there is evidence to the contrary it is submitted that all items on a balance sheet, prepared under the supervision of the directors, should be presumed to be correct.

Profits and Surplus

The Cannon case raises the question of what the legislature meant by "surplus" or "net profits." Statutes in several states read "surplus profits." Whether or not the court will distinguish between "surplus" and "net profits," or consider them one and the same remains to be seen. Upon the face of the statute it seems that dividends may legally be paid from surplus (accumulated profits) or from the net profits of the current fiscal year. Thus, it may be possible to pay dividends from current earnings even though an accumulated deficit exists that is larger than the year's profits. This interpretation is borne out by the fact that the statute provides that dividends may not be paid when the liabilities exceed two-thirds of the assets. It is not likely that any business would have a surplus when the liabilities exceeded two-thirds of the assets, although it is very possible that the year's operation might show a profit under such conditions.

Although the North Carolina Court has had very few cases requiring a definition of profits, there have been many from other sources.[8] One of the best legal pronouncements is given by the Missouri Supreme Court in *Morrow v. Missouri Pacific*,[9] in the following terms: " 'Profits' in the ordinary acceptation of the law is the benefit or advantage remaining after all costs, charges, and expenses have been deducted from the income, because, until then, and while anything remains uncertain, it is impossible to say whether or not

[8] See J. H. Beale, *Stockholders and the Federal Income Tax* (1923) 37 Harvard Law Review 1.

[9] 140 Mo. App. 200, 123 S. W. 1034 (1910).

there has been a profit."[10] Mr. Robert H. Montgomery, a leading accounting authority, uses this language: "The net profit of a business is the surplus remaining from the earnings after providing for all costs, expenses, and reserves for accrued or probable losses."[11] Mr. R. B. Kester explains profits as the difference between income and expense. He says that in the broad sense income is the return from the sale of commodities or services. The price received from the sale is applied first to a recovery of the direct cost of the commodity or service sold. Thus, only the remaining portion of income—usually termed gross profit—is applicable to expenses of operation.[12]

From these definitions it can be seen that it is very difficult to express the meaning of "net profits" with any degree of certainty, but, if the courts would refer more often to accounting authorities, they would avoid some of the unfortunate language that is found. For example, in the case of *St. John v. Erie Railway Co.*,[13] the Supreme Court of the United States said: "Net earnings are properly the gross receipts less the expenses of operating the road to earn such receipts. Interest on debt is paid out of earnings. Many other liabilities are paid out of the net earnings. When all liabilities are paid, either out of gross receipts or out of net earnings, the remainder is the profit of the shareholders, to go towards dividends, which, in that way, are paid out of the net earnings." Another court influenced by the above case has used the following language: "Comprehensively speaking, the net earnings are the amounts of earnings left after deducting the indebtedness of the company from its gross earnings; and it therefore follows that there can be no actual, legitimate net earnings as long as the outstanding indebtedness of the company is greater than its income. In other words a valid dividend can only be declared out of the surplus, after paying all liabilities."[14]

[10] The opinions in the following cases show an understanding of profits: Southern California Home Builders v. Young, 45 Cal. App. 679, 188 Pac. 586 (1920); Cox v. Leahy et. al. 204 N. Y. S. 741, 209 App. Div. 313 (1924); Hill v. International Products Co. et. al. 220 N. Y. S. 711, 129 Misc. Rep. 25 (1925); Jennery v. Olmstead 36 Hun 536 (N. Y. 1885); Eisner v. Macomer, 252 U. S. 189, 40 Sup. Ct. 189 (1920).

[11] MONTGOMERY, AUDITING (students edition) p. 205.

[12] KESTER, ACCOUNTING, THEORY AND PRACTICE, Vol. II, pp. 412 and 414.

[13] 10 Blatchford 279 (N. Y. 1872), affirmed 89 U. S. 136 (1874).

[14] Mangham et. al. v. State, 11 Ga. App. 440, 75 S. E. 508 (1912); For other decisions in which profits are not properly defined see the following: Simcoke v. Sayre, 148 Ia. 132, 126 N. W. 816 (1910), "The term profits has a larger meaning than dividends and covers benefits of any kind, excess of value over

In the above definitions, the courts are confusing liabilities (debts) with expenses. Liabilities should be deducted from assets in order to determine a corporation's net worth, but not from gross income in order to determine net profits. There are very few businesses in the United States that ever would be able to declare a dividend if it were necessary to pay all liabilities first. Bank deposits are banking liabilities, but it would be foolish to attempt to require a bank to pay out all funds on deposit before they could declare and pay dividends.

Income in the broad sense results from any transaction which increases the net worth of a business (excess of assets over liabilities), eliminating additional contributions by the owners and fortuitous windfalls, such as gifts. Operating income is the normal income derived from the main sources of endeavor for which the business was organized. Non-operating or other income is the income which is derived from other than the main sources for which the business was organized and from unusual or extra-ordinary gains.

Expenses result from transactions incurred, in an effort to acquire income, which decrease the net worth of a business. All expenditures of cash are not expenses. Cash may be expended to acquire other assets. This does not decrease the net worth of a business. A withdrawal of profits from the business does result in a decrease in net worth, but such an expenditure is not an expense. Likewise, all receipts of cash are not income. Cash may be received in the payment of an open account. This does not increase net worth. The income arose when the sale was made—when the legal claim arose against the customer. Income and expense are always determined in definite periods of time. The excess of the income over the expense is the net profit for the period. The accumulated net profit which has been left in the business—not distributed to the owners—is surplus. The fact that the cash, accumulated through earnings, is invested in fixed plant, does not affect the amount of the surplus.

Surplus is the excess of assets over the sum of liabilities and capital stock.[15] Surplus may arise from other sources than net profits.

cost, acquisition beyond expenditure, gain or advance"; Bank of Morgan v. Reid et. al., 27 Ga. App. 123, 107 S. E. 555 (1921), "The difference between the present nature of all the corporate assets and the amount of all losses, expenses, other charges and liabilities, including the capital stock, constitutes net earnings for the purposes of dividends"; Thomas v. Matthews, 94 Ohio St. 32, 113 N. E. 669 (1916); Mobile and Ohio Railway Co. v. Tenn., 153 U. S. 486, 497, 14 S. Ct. 968 (1893); Cochrane v. Interstate Packing Co., 139 Minn. 452, 167 N. W. 111 (1918).

[15] MONTGOMERY, FINANCIAL HANDBOOK, p. 213.

The various classes follow:

(1) "Earned surplus"—should include only amounts earned in the operation of the business less losses and earnings distributed.

(2) "Capital surplus"—should include extra-ordinary gains, such as (a) gains through sale of assets other than merchandise, (b) premium of sale of capital stock—sometimes called "paid in surplus," (c) donations to the corporation by stockholders or others, (d) stock assessments, (e) gains made in sale and purchase of the corporation's own stock, (f) bonds redeemed below par, or where borrowings from parties in a foreign country are paid back in depreciated currency, (g) reduction of the par value of the corporation's own capital stock.

(3) "Surplus due to appreciation of fixed or permanent property." This type of surplus represents an unrealized gain and should be clearly ear-marked so that it will not be confused with the true surplus.[16]

THE PAYMENTS OF DIVIDENDS

1. *Dividends from "Net Profits" or "Earned Surplus."*

It is obvious that dividends may be paid from net profits when an earned surplus exists. Under ordinary conditions the courts of this country do not limit the payment of dividends to current operating profits.[17] There is abundant authority that earned surplus or accumulated profits may be paid out as dividends in subsequent years in which no profits are earned.[18] This follows logically from the principle that the control of surplus is regarded as being at the discretion of the directors of a corporation, to pay out in dividends, or retain in the business as they see fit.[19] This statement is a little too

[16] In La Belle Iron Works v. U. S., 256 U. S. 377, 41 S. Ct. 528 (1921), where the invested capital of a corporation was involved in a tax matter, the Supreme Court recognized the difference between paid-up surplus and earned surplus on the one hand, and surplus due to appreciation of assets on the other.

[17] 14 C. J. 808.

[18] Williams v. Western Union Co. 93 N. Y. 162 (1883); Mangham v. State, 11 Ga. App. 440, 75 S. E. 508 (1919); Basset v. U. S. Cast Iron Pipe & Foundry Co. 74 N. J. Eq. 668, 70 Atl. 929 (1908); Mills v. Northern Railway Co., L. R. 5 Ch. App. 621, 23 L. T. 719 (1871); Hoole v. Great Western Ry. Co., L. R. 3 Ch. App. 262, 17 L. T. 193 (1867). *Contra:* Fricke v. Angemeier, 53 Ind. App. 140, 140 N. E. 329 (1912), "A dividend can not be rightly declared until there is a showing that a profit has been really earned for the year such dividend was declared."

[19] Note 17 *supra.*

broad, for, as has been seen, directors are sometimes required by the courts to declare and pay dividends. The rights of preferred stockholders must be considered.[20] It may happen also that current debts of rather substantial amounts are due, even though a valid earned surplus exists. Until these liabilities are either paid or funded, the directors would be unjustified in declaring a cash dividend,[21] for, after being legally declared, dividends become liabilities until paid,[22] and it would certainly be a fraud on the other creditors, whose debts are due, to pay the debts due the stockholders first.

2. *Dividends from "Net Profits" when a "Deficit" exists.*

May dividends be paid from the current year's net profits when an extraordinary loss, or an operating deficit has accumulated from previous years? Where the statute provides that dividends may be paid only from "surplus profits," it appears that it would be illegal to pay a dividend until the deficit had been recovered. But when the statute restricts the payment to "surplus" or "net profits," the answer may be otherwise.

In England the law is clearly settled. A dividend may be paid from profits of one year when an extraordinary loss of fixed capital

[20] Collins v. Portland Electric Power Co. 7 F. (2d) 221 (D. C. Ore. 1925). See also George J. Thompson, *Respective Rights of Preferred and Common Stockholders in Surplus Profits,* (1921) 19 MICH. LAW REVIEW 463. The statutes and contracts regarding preferred stock are divided into two classes.

I. Those statutes or contracts in which the preferred shares are in express terms, or by words of necessary implication, allowed or stipulated, as the case may be, a further participation in the profits after they have received their stipulated dividend.

II. Those statutes or contracts providing for preferred shares entitled to a specified preferential dividend before anything is paid to the common stock, but containing no provision whatever respecting its right to share in any surplus profits in excess of the stipulated dividend.

The decisions of Type II are grouped into three classes:

1. After payment of the agreed preferential dividend, any balance of profits be divided "pari-passu" among both the preferred and common shares. Not followed.

2. Upon payment of the designated preferred dividend, a like annual dividend be paid to the common stock, any profits remaining to be divided equally among both the preferred and common stockholders. Pennsylvania view.

3. When the preference dividend specified has been fully paid, the entire residue of the profits to go exclusively to the common stock. English view and weight of authority in America today.

[21] Comment, "Corporations—Payment of Dividends Without Reference to Outstanding Debts," (1926) 26 MICH. L. REV. 110: "There cannot be a dividend declared unless the outstanding debts are taken care of. . . ." Massoth v. Central Bus Corp., 104 Conn 687, 134 Atl. 236 (1926).

[22] Trustees v. N. C. Railroad Co., 76 N. C. 103 (1877); Benas v. Title Guaranty Trust Co., 216 Mo. App. 53, 267 S. W. 28 (1924).

has not been made up.[23] The Court of Appeals in Chancery has even gone so far as to hold than an impairment of capital, due to an operating deficit, need not be recovered before dividends are declared from the current year's profits.[24]

In North Carolina it seems that dividends might legally be paid from current net profits, although a deficit exists, so long as the liabilities do not exceed two-thirds of the assets. No decisions, however, have been rendered by the North Carolina Court on this point, and there is very little American authority on it. In a Delaware case,[25] where stock had been sold at a discount, a dividend was allowed from current earnings, although the capital paid in plus the profits fell short of the total par value of the stock issued. The Chancellor held that the amount "paid in" constituted the capital and that the statute allowing dividends out of "surplus" or "profits" permitted dividends out of "profits" even if there was no "surplus." As a matter of business policy operating deficits should be recovered before dividends should be declared and paid. In case of unusual and extraordinary losses due to casualties, it seems to be a hardship to require a loss to be made up before the owners may receive any return on their money. If the creditors are protected, there is good argument for permitting the payment of dividends from current profits before the impairment of capital is rectified.[26]

[23] Bosanquet v. St. John D'El Rey Mining Company Limited, 77 L. T. R. 206 (1897); Verner v. Commercial Invest. Trust [1894] 2 Ch. 239, 70 L. T. R. 516.

[24] Ammonia Soda Co. v. Chamberlain [1918] I Ch. 266, 87 L. J. Ch. 193, 118 L. T. R. 48, ". . . It is inaccurate to say that if in subsequent years you pay dividends, having lost capital in previous years, you are paying dividends out of capital that you lost in previous years. It is only possible to support that suggestion by treating the profits when made in a subsequent year as in some way automatically turned into capital, and as replacing the capital which has been lost, and by saying that what was made as profits has in some way automatically become capital and must be treated as capital." See also: Lawrence v. West Somerset Mineral Railway Co. [1918] 2 Ch. 250; Lee v. Neuchatel Asphalite Co. 41 Ch. Div. 1, 58 L. J. Ch. 408, 61 L. T. R. 11 (1889); National Bank of Wale Case [1899] 2 Ch. 629, 68 L. J. Ch. 634, 81 L. T. R. 363.

[25] Peters v. U. S. Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (1921).

[26] HATFIELD, MODERN ACCOUNTING ( ), p. "An individual's entire income is derived from ten houses each worth $10,000 and each yielding 10% net income. If two of these houses burn down, uninsured, the common sense view is that the proprietor's income is thereby cut down from $10,000 to $8,000 per annum, and that coincidentally, there is a loss of capital of $20,000. It never occurs to him that he must consider his income as entirely cut off for two years until the principal can be restored. Similarly it might be an act of cruelty to dependent stockholders to stop dividends entirely until an exceptional loss is reimbursed. The main difficulty is that in a corporation such an occurrence really calls for a reduction of the nominal capital, a cancellation of part of the capital stock—the criticism properly to be made is not so much that dividends

3. *Dividends from "Capital Surplus."*

From the standpoint of corporation finance it usually is not considered good policy to pay dividends from capital gains,[27] but generally speaking there is no legal prohibition against it.[28] Premium on capital stock is also held to be available for dividends.[29] This again is a questionable matter of policy.[30] If additional stock is issued by a corporation that has accumulated a surplus, the premium on the new stock may be credited to surplus so that the amount of

the criticism properly to be made is not so much that dividends are paid before restoring the capital—but rather that the capital stock has not been reduced to correspond with the amount of remaining assets, before the dividend is paid."

[27] See MONTGOMERY, AUDITING (students edition) p. 216, for proposition that capital surplus should not be available for dividends, but should be kept on hand as a proprietorship reserve to take care of possible losses or other capital adjustments.

[28] Mackintosh v. Flint & Pere Marquette Railway Co. 34 Fed. 582, (C. C. E. D. Mich., 1888); Equitable Life Assurance Society v. Union Pacific Railroad Co. 212 N. Y. 360, 106 N. E. 92 (1915); Lubbock v. British Bank of South America [1892] 2 Ch. 198, 61 L. J. Ch. 498, 67 L. T. R. 74.

[29] See Comment, "Corporations—Dividends Payable Out of Premium on Stock," (1926) 4 Nebraska Law Bull. 359. The writer argues that the reason for not allowing dividends to be paid out of capital does not apply because:

1. Dividends out of capital works a fraud upon creditors, who have extended credit on faith of its capital stock, Davenport v. Lines, 72 Conn. 118, 44 Atl. 17 (1899).

2. Each stockholder is entitled to have capital stock preserved unimpaired for the purpose of carrying out the object for which the corporation was formed, Williams v. Western Union Tel. Co. 93 N. Y. 162 (1883).

3. The capital stock of a corporation is a trust fund for creditors, Bank of Morgan v. Reid, 27 Ga. App. 123, 107 S. E. 555 (1921).

4. None of the above reasons apply to the payment of dividends from premium on capital stock.

In this article the writer erroneously argues that premium or capital stock is not earnings, citing: Mangham v. State, 11 Ga. App. 440, 75 S. E. 508 (1912); Goodnow v. American Writing Paper Co., 73 N. J. Eq. 692, 69 Atl. 1014 (1908).

To the effect that dividends may be paid from premiums: Smith v. Cotting, 231 Mass. 42, 120 N. E. 177 (1918); Miller v. Payne, 150 Wis. 354, 136 N. W. 811 (1912); Equitable Life Assurance Society v. Union Pac. R. Co. 212 N. Y. 360, 106 N. E. 92 (1914); Boston & Maine Railroad Co. v. U. S., 265 Fed. 578 (C. C. A. 1st., 1920). *Contra:* Merchants and Insurers' Reporting Co. v. Youts et. al., 27 Cal. App. 889, 178 Pac. 540 (1918); Corliss v. U. S., 7 F. (2d) 455 (C. C. A. 8th., 1925).

In a discussion of Peters v. U. S. Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (1921), it was suggested by Cornelius W. Wickersham in *The Progress of the Law on No Par Value Stock* (1924) 37 HARVARD LAW REVIEW 464, 475, that if more than par value is received (instead of less) the premium constitutes capital. In an article in (1925) 11 A. B. A. J. 380, Mr. William D. Mitchell disagrees with the conclusion reached in 37 HARVARD LAW REVIEW, *supra.*

[30] ESQUERRE, APPLIED THEORY OF ACCOUNTS, p. 331: " . . . premiums obtained on the issue of stock which has a par value are a capital stock liability precisely as they would be if the stock had no par value and there was no accounting objection to stating the capital stock at the amount of its proceeds."

surplus available for dividends on the old stock will not be reduced.[31] A practice of this kind seems proper. In certain promotion schemes the original stock is sold at a premium in order that a dividend may be immediately declared, which is used as a bait to sell stock to the public. The impression given by the promoters is that the company has begun to operate and has earned sufficient profits to declare a dividend—a practice which is clearly fraudulent and should be illegal.[32]

Sometimes, when a hopeless deficit exists, stockholders will amend their charter and have the par value of the capital stock reduced, the difference being credited to surplus, thereby wiping out the deficit. If no creditors' rights are involved, it apparently would be legal for the directors to declare a dividend from surplus so created.[33] It is the stockholders, not the directors, who have reduced the par of the stock. No one is injured if the creditors are protected. The capital stock has been voluntarily reduced by its owners. If a plan of this kind is carried out for the purpose of misrepresenting the facts, in order to sell stock, the guilty parties should be prosecuted under the Blue Sky Laws or for false representations.

4. *Dividends from Surplus Due to Appreciation of Assets.*

The courts of this country follow the accounting point of view in holding that unrealized appreciation of asset values are not available for dividends.[34] There is no question but that this view is sound. There is no assurance that the market will not fluctuate in the wrong direction, and result in a loss, where there was an apparent profit.

[31] Equitable Life Assurance Society of the U. S. v. Union Pac. R. Co., 212 N. Y. 360, 106 N. E. 92 (1914).

[32] Seminole Phosphate Co. v. Johnson, 188 N. C. 419, 124 S. E. 859 (1924). "The statement by an agent of the corporation that a dividend of 14% had been declared on the first issue of stock was in effect a representation that the corporation has a surplus of net profits arising from its business of at least 14% or that its debt, whether due or not, did not exceed two thirds of its assets."

[33] Strong v. Brooklyn R. Co., 93 N. Y. 434 (1883); Continental Securities Co. v. Northern Securities Co., 66 N. J. Eq. 282, 57 Atl. 876 (1904); Jerome v. Cogswell, 204 U. S. 1, 27 S. Ct. 241 (1906); Smith v. Cotting, 231 Mass. 42, 120 N. E. 177 (1918).

[34] Southern California Home Builders v. Young et al., 188 Pac. 586 (Cal. 1920): "Mere estimates of increased value of property owned do not constitute profits. Mere advances in value of property prior to its sale . . . do not constitute profits, because the fluctuations of the market and the uncertainty . . . may bring about a condition where apparent profits turn out to be losses"; Hill v. International Products Co., et. al., 220 N. Y. S. 711, 129 Misc. Rep. 25 (1925); Jennery v. Olmstead, 36 Hun (N. Y.) 536 (1885); Coleman v. Booth *et al*, 268 Mo. 64, 186 S. W. 1021 (1916). See also Hills, *Dividends From Unrealized Capital Appreciation*, (1928) 6 NEW YORK LAW REVIEW, 155, 193.

The surplus account should not be credited with any gain until the sale is actually made. The English view[35] is apparently contrary to the American cases, but, on principle, is clearly wrong. Many accountants argue that a realized capital gain should not be available for dividends, stating that such gains should be reserved to cover possible capital losses and that only surplus accumulated by operating profits should be paid out as dividends. The problem of appreciation of assets through re-organizations is discussed in a subsequent part of this article.

5. *Borrowing to Pay Dividends.*

The fact that the corporation has not sufficient ready cash to pay a dividend, and, therefore, borrows the money with which to pay it, does not render the declaration and payment illegal.[36] Quite often a corporation may invest its working capital in fixed plant, thereby reducing its cash below the amount necessary to pay the regular annual dividend.[37] The real necessity for the borrowing is because the profits have been invested in the plant. Therefore, it may be argued that the borrowing actually was for the property acquired and not for the payment of the dividend.[38] In such cases it may or may not be good policy to declare dividends. There is probably no court in the country that would require directors to borrow money in order to be able to declare dividends.[39] Whether funds accumulated through profits shall be paid out in dividends or invested in the expansion of the business is usually in the discretion of the directors.[40] From a business point of view it is merely a question of whether or not the working capital (current assets minus current liabilities) is sufficient. The limitation is whether maturing liabilities are taken care of.

6. *Stock Dividends.*

It is usually held that a stock dividend must be declared from surplus or net profits just as if it were a cash dividend.[41] Some of

[35] Stapley v. Read Bros. Ltd. [1924] 2 Ch. 1, 93 L. J. Ch. 513, 131 L. T. 629.
[36] Cox v. Leahy, et. al., 204 N. Y. S. 741, 209 App. Div. 313 (1924).
[37] Williams v. Western Union Tel. Co. 93 N. Y. 162 (1883): "A corporation may pay a dividend out of surplus though this surplus has been invested in plant. Such surplus is not beyond the reach of the dividend making power of the directors. They can borrow money on the faith of it and declare a cash dividend. . . ."
[38] Excelsior Water & Mining Co. v. Pierce, 90 Cal. 131, 27 Pac. 44 (1891).
[39] Stevens v. U. S. Steel Corp. 68 N. J. Eq. 373, 59 Atl. 905 (1904).
[40] Mark v. American Brewing Co., 126 La. 666, 52 So. 983 (1910).
[41] Hite v. Hite, 93 Ky. 257, 20 S. W. 778 (1892).

the courts seem not to realize that a stock dividend takes no assets from the business.[42] It merely represents a transfer from the surplus account to the capital stock account. It is a declaration by the directors that the amount of the stock dividend has been added to the permanent capital of the corporation. The North Carolina Court has held that existing creditors could not recover from a stockholder who received stock as a dividend with knowledge that no surplus existed, for nothing was taken from the business; but subsequent creditors, on the theory that the capital stock is a trust fund for creditors, may hold the stockholders liable.[43] There is no doubt about this case being sound as to the first part, and if the trust fund theory be recognized, the second part is also sound, but the trust fund theory is under fire.[44] Generally a creditor looks at the assets of the business and not at its capital stock when he considers its responsibility.

The legal objection to dividends from unrealized appreciation of assets does not apply with such force to stock dividends, since nothing is taken from the business. However, this violates conservative accounting practice which requires that capital assets be carried on the balance sheet at cost less depreciation. Since, from the corporation's standpoint, a stock dividend is a mere book entry and does not represent a distribution of assets or an increase in liabilities, it is well to consider how the receipt of this stock should be treated by the stockholder.[45] In the past, capital stock has been shown as a liability on the financial statements prepared by many corporations, but according to modern accounting practice, the net worth of a corporation should be shown separate from the liabilities, and the capital stock should be shown as one item of net worth. The corporation's liability to its stockholders is not of the same character as its liability to creditors. Whatever may be the effect of a stock dividend upon the corporation's accounts, the stockholder who receives it has no more than he had before, except that the same value is represented by additional shares of stock.[46] However, he is assured that the addi-

[42] Alfred J. Brown Seed Co. v. Brown, 240 Mich. 569, 215 N. W. 772 (1927): "A corporation can declare dividends only out of its surplus profits, and not out of its capital stock thereby reducing the same, nor out of assets which are needed to pay the corporate debts, and this applies to stock dividends as well as cash."

[43] Whitlock v. Alexander, 160 N. C. 465, 76 S. E. 538 (1912).

[44] Hollins v. Brierfield Coal and Iron Co., 150 U. S. 371, 14 S. Ct. 127 (1893).

[45] Thomas Reed Powell, (1922) *Income from Corporate Dividends*, 35 HARVARD L. REV. 363; Sexton v. C. L. Percival Co. et al., 189 Ia. 586, 177 N. W. 83 (1920).

[46] Towne v. Eisner, 245 U. S. 418, 38 S. Ct. 158 (1918); Eisner v. Macomber, 252 U. S. 189, 40 S. Ct. 189 (1920).

tional value of his shares, due to the corporation's accumulation of profits, will be permanently added to his capital, unless he chooses to sell some of his shares. When a stock dividend is declared from surplus that amount is no longer available to be declared as a cash dividend by directors.

An interesting question arises in connection with a stock dividend when the original stock was owned by a trust, and the trust provision is that income shall go to the life tenant and the principal to a remainderman. Does the stock dividend belong to the life tenant or to the remainderman? The whole question of the apportionment of income between the life tenant and remainderman has given rise to much controversy.[47] A bill for a uniform act on the subject is now being drafted by the National Conference of Commissioners on Uniform State Laws. A stock dividend represents no increased value, but merely the same value divided into additional shares. From an accounting point of view, it does not represent income and should not be given to the life tenant. If the stock received as a dividend should be sold, an accountant, in order to determine whether a profit was made, would divide the total cost of the original share by the total number of shares owned after the stock dividend was received,

[47] That profits on sales of stock owned by the trust generally go to the remainderman see cases cited in Note (1921) 13 A. L. R. 1004-1018.

That corporate stock dividends and share rights are a part of principal and belong to the remainderman see: Minot v. Paine, 99 Mass. 101 (1868); Gibbons v. Mahan, 136 U. S. 549, 10 S. Ct. 1057, 34 L. Ed. 525 (1890); Lamb v. Lehmann, 110 Oh. St. 59, 143 N. E. 276, 42 A. L. R. 437 (1924); New York Laws 1926, Ch. 843; Conn. Gen. St. 1918, §5041; Georgia Code, 1926, §3667. *Contra:* Sexton v. C. L. Percival Co., 189 Iowa 586, 177 N. W. 83 (1920). In this case, it was held that a stock dividend paid from surplus was a distribution of profits and belonged to the life tenant. The court said "In a sense every stock dividend is a matter of book-keeping. The accumulated profits, whether in money or property, are undisturbed. It results in a corresponding increase in capital stock, and this for the purpose of distributing such profits or income pro-rata to the shareholders, and in that manner capitalize the earnings." The court's statement here is inconsistent, for if the earnings are capitalized, they are not distributed. The owner of the stock has additional shares but no more value, nor has he realized any income. See note 46 *supra*. The fact that the stock dividend is declared from the surplus of the corporation has no bearing on whether the recipient has received income.

For the Pennsylvania rule, see *In re* Nirdlinger's Estate, 290 Pa. 457, 139 Atl. 200 (1927); Jones v. Integrity Trust Co., 292 Pa. 149, 140 Atl. 862 (1928). This rule calls for an apportionment of share dividends as to the time when the fund out of whcih they are declared was earned. The life tenant is given all such dividends declared out of earnings of the corporation after his interest accrued.

For general discussion see (1928) 37 YALE L. J. 382; (1923) 23 COLUMBIA L. R. 369; (1926) 39 HARVARD L. R. 905; (1928) 26 MICH. L. R. 555; (1927) 11 MINN. L. R. 659; (1926) 74 U. OF PA. L. R. 618; (1926) 4 VA. L. R. 660.

and this quotient would be subtracted from the sale price per share. The various ways in which courts have dealt with this problem is discussed below.

Dividends on No Par Value Stock

Practically every state in the United States authorizes the issuance of no par value stock.[48] Where capital stock with a stated par value is issued, it is the stock that is valued, and property should exist to the amount of the valuation placed upon the outstanding stock. In the case of no par value stock, however, it is the assets which are valued, and the net assets value is automatically the value of the total shares outstanding.[49] The problem of keeping track of the permanent capital of a corporation is made more difficult when no par value stock is issued. If the stock has a stated par value, the total par value of the outstanding stock represents the capital which is not available for dividends. However, in case of no par value stock the directors may put an arbitrary value on the capital stock, call the remainder surplus, and pay it out in dividends. In North Carolina this depletion of capital probably would not be illegal so long as the liabilities did not exceed two-thirds of the assets. Good accounting practice requires that the total money or other property paid in for the shares of stock be credited to the corporation's capital stock account, and this amount should not be available for dividends. Possibly the greatest abuse in connection with paying dividends out of capital arises through mergers. Assume three companies, "A," "B," and "C." They decide to merge as of December 31, 1927. At that date their position was as follows:[50]

	Capital	*Earned Surplus*	*Net Worth*
A	$ 100,000.00	$ 100,000.00	$ 200,000.00
B	300,000.00	500,000.00	800,000.00
C	600,000.00	400,000.00	1,000,000.00
	$1,000,000.00	$1,000,000.00	$2,000,000.00

For the sake of simplicity assume that each of these companies has par value stock at $100 per share. Assume that in the plan of the

[48] Montgomery, Financial Handbook, p. 562. See also N. C. Cons. Stat. Ann. (1919), §1167 (a), granting corporations power to issue no par value stock in North Carolina.

[49] F. H. Hurdman, President American Institute of Accounting, paper delivered before N. C. Assoc. of C. P. A.'s at Charlotte, N. C., Oct. 19, 1928.

[50] The illustration given is borrowed in part from illustrations used by Mr. F. H. Hurdman in the paper referred to in note 49 *supra*.

merger Corporation "C" shall recapitalize and shall obtain power to issue 60,000 shares of no par common stock. Corporations "A" and "B" are dissolved. The merger agreement provides that the net assets of "A," "B," and "C" shall be taken over at the appraised value of $3,000,000 for the 60,000 shares of no par stock, to be allocated as follows:

Capital	$1,000,000, the original asset book value.
Capital Surplus	1,000,000, the increase in value due to appraisal.
Earned Surplus	1,000,000, the original earned surplus.

It seems that in a situation of this kind nothing in the North Carolina law prevents the payment of the $2,000,000 surplus as dividends, although the $1,000,000 capital surplus really represents unrealized appreciation in asset values.

Sound accounting principles dictate the following set-up:

Capital Stock	$2,600,000
Surplus	400,000
	$3,000,000

The surpluses of Corporations "A" and "B" disappear, since their assets were purchased by Corporation "C."

There is some argument that the surpluses of "A" and "B" should be carried forward, since the holdings of the stockholders in Corporation "C" represent the same asset value as was owned before the merger occurred. Under the logic of such argument, the net worth section of the balance sheet would appear as follows:

Capital Stock	$2,000,000
Surplus	1,000,000
	$3,000,000

It seems desirable that the court should "look through" reorganizations in order to prevent the creation of surplus that really represents unrealized appreciation of asset values. By following the practice described above the new corporation may pay out a part of the capital of the old companies in the guise of surplus. There is no objection to the stockholders withdrawing a part of the capital of the corporation if creditors are not injured, but the withdrawals should be shown as a withdrawal of capital and not as a dividend

from surplus. The danger lies in the fact that future investors may be deceived as to the dividend paying ability of the corporation, or that some of the present owners of the capital stock, who are not so familiar with corporate procedure, may not realize that a part of their invested capital is being returned.

The principle of no par value stock is sound. Investors are not fooled by the one hundred dollar value stamped on the certificate of par value stock. The no par value share makes the investor realize that he is acquiring only a definite fraction of the net asset value of the corporation. Another and probably the main argument for no par stock is that it removes one of the incentives for overvaluation of assets. In most states par value stock cannot be issued at a discount. To avoid this provision many corporations have issued stock for intangible assets greatly in excess of the value of the assets required. The owners would immediately donate a part of the stock so acquired to the corporation which then would proceed to sell that stock at a discount for the purpose of raising the required working capital. It is evident that this would cause an overvaluation of the assets which would be reflected in the capital stock and surplus accounts.[51]

The greatest argument against no par stock, which can be solved by coöperation between lawmakers and accountants, is the ease with which the paid-in capital of a corporation may be lost sight of.

Conclusion

The North Carolina statute[52] provides that "no corporation may declare and pay dividends except from surplus or net profits arising from its business, or when its debts, whether due or not, exceed two-thirds of its assets. . . ." The ideal law would restrict the payment of dividends to earned surplus. In determining whether an earned surplus exists, the court should see if the accumulated net profits of the corporation exceed its losses and earnings distributed. The financial statements prepared by the directors should be considered prima facie correct. The assets of a business should be valued on the basis of a going concern and not on the basis of cash realizable value. The Cannon case did not make this distinction. If a deficit exists, either due to operating losses or to extraordinary losses, the directors should not be allowed to declare and pay dividends until

[51] Note 50 *supra.*
[52] Note 1 *supra.*

the deficit is recovered. If the stockholders do not desire to recover the deficit before receiving dividends, they should reduce the amount of the corporation's capital stock, as provided by law. After the deficit has been absorbed in that way, any accumulation of earnings could immediately be paid out as dividends by the directors. If a capital surplus exists, due to the sale of capital assets at a profit or otherwise, it should be clearly earmarked, and the directors should not be allowed to declare a dividend from funds so derived without a vote of the stockholders. Capital gains are unusual in their nature, and the stockholder should realize that a dividend from this source does not constitute a regular dividend that he may expect to receive in subsequent years.