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Payment of Dividends in Louisiana From Unrealized Appreciation of Notes, Bonds, or Obligations for the Payment of Money

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"It may seem strange also that if this case had been tried originally in the Criminal District Court the defendant would have had no right of appeal to the Supreme Court even on questions of law, because the penalty actually imposed is neither a fine exceeding $300 nor imprisonment for a term exceeding six months."

If the Louisiana Constitution is revised, the provision in Section 96 of Article VII should be analyzed and its respective advantages and disadvantages carefully weighed. It is submitted that this provision for appeal from the Orleans Parish Juvenile Court should be changed to conform to the rule of appeal for all other juvenile courts of this state — a rule which fits logically into the general pattern of Louisiana Supreme Court appellate jurisdiction.

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PAYMENT OF DIVIDENDS IN LOUISIANA FROM UNREALIZED APPRECIATION OF NOTES, BONDS, OR OBLIGATIONS FOR THE PAYMENT OF MONEY

The practical impossibility of accurately evaluating corporate assets, plus the ever present temptation to overvalue those assets in order to present a favorable financial picture and to enable directors to comply with the insatiable demands of stockholders for immediate dividends, has led to the generally accepted rule of law that unrealized appreciation of corporate assets may not be used in calculating funds from which dividends may be paid.[1] Several states have by statute specifically adopted this rule.[2] Even where the state statute has failed to cover the point precisely and has merely stated that dividends are to be paid from surplus, or from net worth over capital, or from assets over liabilities, the courts have uniformly read in an implied prohibition against the inclusion of unrealized appreciation.[3] The fundamental soundness of this limitation is graphically

1. Ballantine, Corporate Capital and Restrictions upon Dividends Under Modern Corporation Laws (1935) 23 Calif. L. Rev. 229, 259; Bonbright, Theory of Anglo-American Dividend Law: Surplus and Profits (1930) 30 Col. L. Rev. 330, 341.

2. Idaho Code Ann. (1932) §§ 29-129; Ill. Rev. Stat. Ann. (Smith-Hurd, 1935) tit. 32, §§ 157.41c; Ind. Stat. Ann. (Burns, 1933) §§ 25-211; Ohio Gen. Code Ann. (Page, 1938) §§ 8623.38; Pa. Stat. (Purdon, 1938) tit. 15, §§ 2852-701-(1). Contra: Wis. Stat. (1939) §§ 182.19, criticized by Geraldson, Limitations on Dividends (1934) 10 Wis. L. Rev. 269.

3. Hills, Dividends From Unrealized Capital Appreciation (1928) 6 N. Y. L. Rev. 155 contains resume of cases showing historic attitude of American courts

evidenced by the fact that a rise in values, creating an unrealized surplus, may be reversed shortly and without advance warning.

While the Louisiana Business Corporation Act[4] prohibits the use of unrealized appreciation of fixed assets and inventories in estimating funds available for dividends, it apparently allows a corporation to pay dividends based upon such appreciation in the value of readily marketable notes, bonds, or obligations for the payment of money possessed by the corporation.[5] The applicable portions of Section 26 of the Corporation Act read as follows:

> "I. No corporation shall pay dividends in cash or property,
>
> (a) except from the surplus of the aggregate of its assets over the aggregate of its liabilities, plus the amount of its capital stock: or
>
> (b) out of any surplus due or arising from
>
> (1) any profit or treasury shares before resale; or
>
> (2) any unrealized appreciation in value or revaluation of fixed assets; or
>
> (3) any unrealized appreciation in value or revaluation of inventories before sale; or
>
> (4) the unaccrued portion of unrealized profit on notes, bonds or obligations for the payment of money, *purchased or otherwise acquired, unless such notes, bonds or obligations are readily marketable, in which case they may be taken at their actual market value; . . . .*"

The Louisiana Business Corporation Act of 1928 was copied, with few alterations, from the Model Business Corporation Act,[6] which provided merely that unaccrued portions of unrealized profits on readily marketable notes, bonds, or obligations for the payment of money *purchased or acquired at a discount* could be taken at

to the effect that unrealized appreciation in the value of buildings, inventories, stock, bonds, etc., was not profit available for the payment of dividends. Accord: Bonbright, supra note 1, at 330, 341, 985. Sparger, The Payment of Dividends (1929) 8 N. C. L. Rev. 14, 23. Contra: Randall, as trustee of Bush Terminal Co. v. Bailey, 23 N. Y. S. (2d) 173 (S. Ct. 1940), criticized in Note (1940) 54 Harv. L. Rev. 505.

4. La. Act 250 of 1928 [Dart's Stats. (1939) §§ 1080-1154].

5. But see United States v. Ogilvie Hardware Co., 155 F. (2d) 577, 579 (C. C. A. 5th, 1946) where the court, referring to La. Act 250 of 1928, § 26 [Dart's Stats. (1939) § 1106] stated ". . . and expressly excludes from the surplus a number of unrealized values such as appreciation in real estate not sold, profits on notes purchased which have not accrued or been realized and the like."

6. 9 U. L. A. 112 (Perm. ed. 1932).

market value in estimating surplus available for payment of dividends.[7] It is significant to note that the limitation "purchased or acquired *at a discount*" was omitted in the Louisiana Business Corporation Act. Thus unrealized appreciation from *all* readily marketable notes, bonds, et cetera, may be counted for dividend purposes.

This liberal Louisiana law, by sanctioning the payment of dividends based upon a surplus of such unrealized profit, permits unsound financial practices which could be used to place a corporation in very dangerous circumstances. It must be admitted that in some cases there is a marked lack of correlation between market value and the inherent value of securities. Today's market appreciation may be tomorrow's market depreciation. For example, let us suppose the frequent situation where an apparently sound rising market is unexpectedly interrupted by a declining market. Dividends have been authorized and paid based upon the increased price of the securities held by the corporation. Now the shareholders are faced with the unpleasant realization that the temporary surplus is dissipated and the dividends received really represented a reduction of their actual capital investment. If the dividends were substantial they might well serve to impair the financial stability of the entire corporate enterprise.

Numerous legal writers have discussed this problem and have almost unanimously condemned the payment of dividends based upon unrealized appreciation of corporate assets.[8]

The careful draftsmanship of the Louisiana Business Corporation Act is clearly indicated by the paucity of cases arising under it. At the same time, one may question the practical wisdom of authorizing the use of unrealized appreciation in notes, bonds, et cetera, in

7. 9 U. L. A. 112, 114 (Perm. ed. 1932).

8. Ayer, Funds Available For Corporate Dividends in Washington (1934) 9 Wash. L. Rev. 63, 123, 135. Comment (1928) 28 Col. L. Rev. 231; Comment (1935) 10 Wis. L. Rev. 269; Comment (1936) 35 Mich. L. Rev. 286; Note (1941) 54 Harv. L. Rev. 505; Comment (1942) 90 U. of Pa. L. Rev. 338.

The only article found which sought to uphold the payment of dividends from unrealized appreciation of assets was a Note in (1941) 18 N. Y. U. L. Q. Rev. 262 which discussed the case of Randall, as Trustee of Bush Terminal Co. v. Bailey, 23 N. Y. S. (2d) 173 (S. Ct. 1940). That writer would merely add the requirement that corporate directors must exercise due care. But this would seem to be implied in the payment of all dividends. Furthermore, one of the reasons behind the general prohibition against such use of unrealized appreciation is that corporate directors using the utmost care cannot with any certainty predict market trends. It is interesting to note that the case of *Randall v. Bailey*, supra, which was under discussion in that article involved the receivership of a corporation which had floundered on the shoals of financial insolvency through the use of unrealized appreciation in the value of land as a basis for the payment of dividends for the years 1928 through 1932.

estimating funds available for the payment of cash or property dividends. Such a rule not only permits unwitting dissipation of corporate assets, but creates opportunity for unscrupulous directors to develop an entirely false impression as to the inherent earning capacity of the corporate enterprise.

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